S. HRG. 102-56

THE FINANCIAL CONDITION OF THE SECURITIES INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

WHETHER THE ECONOMIC DOWNTURN PRESENTS UNDUE RISKS FOR INVESTORS AND THE FINANCIAL SYSTEM; WAYS THE SECURITIES AND EXCHANGE COMMISSION SHOULD ADAPT ITS EFFORTS TO CHANGING CONDITIONS IN THE INDUSTRY; THE SECURITIES INDUSTRY'S ABILITY TO MEET BUSINESS AND GOVERNMENT'S FUNDING NEEDS IN THE CURRENT ECONOMY; AND THE ADEQUACY OF THE SEC'S REGULATORY TOOLS AND STAFFING RESOURCES TO ASSESS RISKS AND PROTECT INVESTORS

JANUARY 8, 1991

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

42-559 WASHINGTON : 1991

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S241-40

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, JR., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH JR., Delaware
PETE V. DOMENICI, New Mexico
NANCY LANDON KASSEBAUM, Kansas

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
LAMAR SMITH, *Republican Staff Director and Economist*
SHARON B. HEATON, *Counsel*

SUBCOMMITTEE ON SECURITIES

CHRISTOPHER J. DODD, Connecticut, *Chairman*
JOHN HEINZ, Pennsylvania, *Ranking Minority Member*
MARTHA L. COCHRAN, *Staff Director and Chief Counsel*
MICHAEL J. STEIN, *Financial Policy Analyst*
BRADLEY D. BELT, *Republican Counsel*
IRA PAULL, *Republican Counsel*

CONTENTS

TUESDAY, JANUARY 8, 1991

	Page
Opening statement of Senator Dodd	1
Opening statements of:	
Senator Riegle	2
Senator Heinz	5
Senator D'Amato	5
Senator Sanford	4
Senator Sasser	46

WITNESSES

Hon. Richard C. Breeden, Chairman, Securities and Exchange Commission, Washington, DC	6
Prepared statement	13
The U.S. securities industry during the 1980's	14
Profitability	16
Revenues and expenses	17
Effect on the securities industry of a general recession	19
International competition	20
Industry capital	20
The state of the SIPC fund	23
The state of the investment management industry	24
Conclusion	25
Response to written questions of:	
Senator Riegle	145
Senator Sanford	156
Witness discussion:	
Possible problem areas	26
Toughening of the current rules	29
Possible new developments in the securities industry	31
Firms engaging in riskier activities	32
Risks to the small investor	35
Modernization of the U.S. financial industry	36
Capital gains tax	39
Municipal securities	40
Sales practice regulation	42
Protecting investors in failed banks and thrifts	45
Foreign investors	49
Insolvency of holding companies	51
Gedale Horowitz, chairman, Security Industry Association, Washington, DC	54
Prepared statement	61
Executive summary	61
Current state of the industry	63
The long term outlook for and value of an independent securities industry	65
The SEC and regulation	66
Savings and investment	67
International concerns	67
Financial restructuring and deposit insurance reform	68
Appendix A	71
Appendix B	78
Michael Goldstein, senior research analyst, Sanford Bernstein and Co., New York, NY	103

Page

Michael Goldstein, senior research analyst, Sanford Bernstein and Co., New York, NY—Continued
Prepared statement 105
State of the securities industry 105
Financial health of the industry 106
Regulation of the industry 106
Material submitted by the Securities Industry Association 107
Panel discussion:
Financial restructuring 134
Money market funds 134
Long-term prospects of the industry 135
Individual investors 136
Financial services reform 139
Municipal securities market 141

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Wall Street Journal newspaper article, dated Dec. 14, 1990, by George Anders, entitled "Captive Client" 165

THE FINANCIAL CONDITION OF THE SECURITIES INDUSTRY

TUESDAY, JANUARY 8, 1991

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Christopher J. Dodd, (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The subcommittee will come to order.

This morning, the subcommittee convenes for the purpose of conducting a hearing on the condition of the securities industry as we enter 1991.

Let me, first of all, welcome everyone here this morning to our hearing.

And let me thank our witnesses for coming. Listening to the weather reports out of Washington, yesterday, I thought we wouldn't get down here for a week. I'm delighted everyone could make it here this morning.

I also want to thank Chairman Riegle of the full committee for allowing me to conduct these hearings at this time, before the committee has organized for the new Congress.

I think everyone recognizes that very shortly, the full committee will have to turn its attention to the problem of funding for the Resolution Trust Corporation, and then immediately begin work on what we all agree is vitally important legislation to address deposit insurance reform, and other banking legislation.

With the securities industry ending its worst year in over 15 years, and expected to show a net loss, industry-wide, for 1990, I thought, it would be important for us to ask its top regulator to appear before the subcommittee to talk about the implications of these problems for the securities industry, itself, for the financial system, and for our economy as a whole.

This is not something I felt should be put off until March or April.

And, again, I appreciate the willingness of Senator Riegle to allow the subcommittee to move ahead at this early date.

I want to add that the subcommittee's ranking minority member, Senator Heinz, who I understand will be here a little later and who has been, as many of you know, an important partner in all of the

subcommittee's work over the last 2 years, agreed that this is something we ought to do at this time.

Our concern, this morning, obviously, is much broader than the health of this one industry.

We are entering an economic recession of unknown depth and length, with the financial system as a whole in a seriously weakened condition.

Obviously, the events of the last 48 hours in my own part of the country, with the Bank of New England situation and Connecticut Bank & Trust, and others, is evidence of the kind of difficulty we're in.

So I'm stating the obvious, in a sense, when I talk about the general condition of our economy.

The banks, as we all know, have reduced their lending activities substantially.

The insurance industry is under stress.

And obvious sources of credit have been constricted.

We are all asking the question, who will supply the money for businesses that need funds to tide them over through the rough times that are ahead, and for businesses that will need funds for growth and expansion, as part of a future economic recovery?

Who will supply the money for the counties and cities across this nation whose tax bases were declining, even before the recession. The crumbling infrastructure and the inadequate educational and health care facilities of these cities will mean greater costs for our society in the future, if they're not addressed as soon as possible.

The securities industry, in the past, has played a vital role in raising capital for business and industry. It has been a partner of cities and counties that have tapped the capital markets for funds.

Yet, the securities industry enters the economic recession in what we all might term, a recession of its own. Confidence is sagging nationwide. Billions of dollars of investor funds are sitting on the sidelines.

Some of this, obviously, is due to problems beyond the control of a single regulator—uncertainty over the Gulf crisis, uncertainty about the length and depth of the recession, itself.

But in this environment, it is absolutely essential that the SEC do its part to head off problems that may be on the horizon; to take quick, tough enforcement and regulatory action to address the problems at hand; and to do its best to restore and maintain confidence in our markets.

That's the reason we're here this morning, to address those basic questions.

Before we begin, I have statements from Senators Riegle and Sanford to be inserted in the record.

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. I want to commend you, Senator Dodd, for moving ahead with an oversight hearing on the securities industry—an industry which, as we all know, is critical to capital formation and capital flow in this Nation.

Before I go into the substance of the matter before us, I want to take this occasion to compliment Senators Dodd and Heinz, as

chairman and ranking member of the Securities Subcommittee, for their fine work in the 101st Congress. Through their efforts, Congress enacted three separate securities bills: the Market Reform Act, the Securities Law Enforcement Remedies Act and the Penny Stock Reform Bill and the Securities Amendments Act. These legislative accomplishments will aid in stabilizing the securities markets during times of stress and deterring securities law violations by supplementing the enforcement powers of the Securities and Exchange Commission. I want to commend you both for your succcess in these areas.

Turning to today's hearing on the condition of the securities industry, recent news from the securities industry is not encouraging. Last week, the Wall Street Journal reported that U.S. securities firms "are expected to post a pre-tax loss of as much as $50 million—the worst year for Wall Street profits since 1974." In fact, 1990 would mark the first year since 1974 in which the securities industry actually incurred a loss. Even in 1987, the year of the market crash, the securities firms profited. So I must ask, what happened in 1990? Further, I am interested in the witnesses' opinions on the soundness of the industry and whether you believe 1991 will also see losses.

In addition, I have a more specific issue I would like to raise. On December 27, 1990, an electrical explosion occurred outside the building where the Securities Industry Automation Corp. is located. The Securities Industry Automation Corp. is the computer center for the New York and American Stock Exchanges. Although these computers were apparently unaffected by the explosion, Exchange personnel were unable to gain access to them until New York City officials determined that it was safe to enter the building. Without access to these computers, the New York Stock Exchange was unable to open, resulting in a halt of all exchange-based trading for 90 minutes.

While this is a serious event, it is all the more so since similar events caused trading halts on two other occasions in 1990. I would like to understand what steps are being taken to provide the system with greater stability.

The December 27, 1990 trading halt highlights another growing trend in the securities markets. Although the SEC ordered a temporaary trading halt on U.S. stock exchanges, institutional investors continued to trade securities off the exchanges. I question the fairness of allowing some people to trade when the individual investor is blocked from access to the securities markets. Of course, we should not place so many restrictions on institutional investors that they choose to trade overseas rather than in domestic markets. I would appreciate the witnesses' thoughts on how to balance these interests.

Once again, I want to commend Senators Dodd and Heinz for holding this hearing. I especially want to welcome you, Chairman Breeden; as always, it is a pleasure to see you. I also want to welcome Mr. Horowitz, who is making his first appearance before us as chairman of the Securities Industry Association. I look forward to your comments and those of the other distinguished panel of experts before us.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I appreciate your efforts in pulling together this hearing at this time and I thank our witnesses for their thoughtful and comprehensive testimony.

The subject of this morning's hearing, the financial condition of the securities industry, following as it does the announcement yesterday of the Bank of New England's failure only serves to highlight the difficulties facing our financial services industry. Unfortunately, the news from the securities industry is not significantly better than some of the news from the banking industry. For the first time in 15 years, the industry suffered an overall, industry-wide loss in 1990. In the last 3 years, 45,000 employees in the securities industry have lost their jobs. Profits have been squeezed, trading volume has fallen and many of our major firms have had to seek large capital infusions from their parent companies.

Looking behind much of data presented to us today raises additional concerns. In looking at the types of products and services that earn revenue for the industry, it becomes clear that commission revenue is not producing growing revenues, and while other traditional sources of revenue, such as underwriting, is not a source of income growth. Indeed, the firms that have made money in the recent years have done so largely through expansion into riskier activities, such as mergers, private placements and trading for their own account. The downturn in merger and takeover activity is likely to reveal even deeper problems within the industry.

Based on this data, I think it is important to examine whether anyone is making a profit in this business. We also should look at whether the downturn we have seen is merely cyclical or a function of broader problems in our capital markets.

Given the crucial role that our securities industry has played and must play in future in raising capital, both for private industry and for our fiscally beleaguered cities and counties, it is imperative that we have a securities industry that is strong and well-regulated. I look forward to hearing testimony this morning of how we insure that such a sound and stable industry emerges from the difficult period we are examining this morning.

Again, I thank our witnesses for being with us, and particularly want to thank Dale Horowitz and the Securities Industry Association for the helpful data they have provided for the committee.

Senator DODD. And I'd like to welcome our first witness, of course well-known to the subcommittee and those in the room today, Richard Breeden, the Chairman of the SEC, and thank him for his willingness to come on fairly relatively short notice and appear before the subcommittee and address some of these basic questions.

I see my ranking minority member arriving on time.

Are you prepared with an opening statement?

Senator HEINZ. Absolutely, Mr. Chairman.

Senator DODD. Well, then Richard, I'll turn to Senator Heinz first, and then we'll turn to our first witness.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. As you were saying, Mr. Chairman, I'm pleased to join you in welcoming the distinguished Chairman of the Securities Exchange Commission, Richard Breeden, and our other distinguished witnesses who I see in the audience, as we examine the condition of the securities industry.

These hearings present us with the opportunity to take stock of the securities industry.

In 1990, the industry closed on a down tic, and is expected to report its first annual loss since 1974.

Securities industry profits have proven to be as volatile, unfortunately, as our stock markets.

The industry is confronting some sobering realities now that merger mania, which sustained industry profits throughout much of the 1980's, has apparently come to an end.

Although the current condition of the securities industry is far from a picture of health, this is no time to sell the industry short.

Firms are building capital, slashing overhead costs, and consolidating operations, in preparation for intense global competition ahead.

Mr. Chairman, the securities markets of the 1980's were confronted by rapid changes, brought about by institutionalization, internationalization, and technological innovation.

While our markets have indeed changed, the vital importance of capital to our economy has remained the same.

I look forward to exploring, with you, whether the securities industry and our financial markets can provide the capital necessary to sustain this Nation in the new decade of the 1990's.

Senator DODD. Thank you very much, Senator Heinz.

I should have noted, at the outset, that following Richard Breeden, we will be hearing from Gedale Horowitz, the chairman of the Securities Industry Association, and Michael Goldstein, who's a senior research analyst with the Sanford Bernstein & Company.

I want to thank both of them, as well, for being here this morning.

Senator HEINZ. Mr. Chairman, I'd ask that a statement by Senator D'Amato be included in the record.

Senator DODD. Without objection, it is so included.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, thank you for convening this hearing today to examine the financial condition of the securities industry. Now that the excesses of the 1980's have ended, investors are tightening their belts on their way into the 1990's.

As we head further into the new decade, there is a host of new concerns that face investors and regulators alike. We need to restore the individual investor's confidence in the securities market. This confidence was severely shaken during the market collapse of October 1987 and has never been fully regained.

The taxpayer burden involved in the savings and loan clean-up has also weakened investor's confidence in financial institutions in general. I do not believe that people have quite resorted to storing

money in their mattresses rather than in banks but financial institutions as a whole are experiencing serious credibility problems.

I would especially like to see the effect that restoring confidence in the securities market would have on Wall Street. Out of 100,000 jobs lost by New Yorkers last year, approximately 60,000 of these jobs are attributed to Wall Street lay-offs.

I will be interested in hearing the agenda of the regulators in light of the changing focus of the securities industry. In particular, given the lagging economy, I would like to know what actions the SEC has taken recently to protect investors with respect to the financial reporting area, including whether there is heightened scrutiny of public corporations' filings with the Commission.

Another area I am concerned about is how the weakened U.S. securities industry will compete on a global basis with its better capitalized competitors. I have been a proponent of enlarging the scope of banks' activities for several years, and would like to know how the current economy and condition of the banking and securities industry as a whole impacts on the feasibility of this.

Thank you, Mr. Chairman.

Senator DODD. Chairman Breeden.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. BREEDEN. Thank you very much, Mr. Chairman.

It is my pleasure to start a new year by appearing before this subcommittee to report on the state of the U.S. securities industry.

At the outset, let me say that as the Securities and Exchange Commission enters this year, we will be dealing with the condition of the securities industry with substantially enhanced tools with which to monitor the situation, and to take appropriate corrective action where necessary.

Those tools, provided in the Market Reform Act of 1990, and the Securities Law Enforcement Remedies Act of 1990, would not exist without the leadership of this subcommittee and without the personal efforts and leadership of Chairman Dodd and Senator Heinz.

The Commission is certainly greatly appreciative of the efforts of the subcommittee and the full committee to spearhead that legislation.

We believe it represents, collectively, some of the most significant legislation in the securities field in decades, and is something that we believe, for the long run, will enhance our ability to monitor and oversee conditions in the securities industry.

The U.S. securities markets continue to be, by far, the best source of return for ordinary American savings for the long haul.

For example, an investor who put $100 in Treasury bills in the year 1926 would have about $1,043 today. However, if that same person had invested that same $100 in the stocks that comprise the Dow Jones Industrial Average in 1926, that investor, even after going through the crash of 1929 and the market breaks of October 1987 and October 1989, would have almost $52,000 today as a return from that $100 investment.

This historic pattern has certainly continued to be true in recent years.

The Dow Jones Industrial Average grew from 838.74 on January 1, 1980, to 2633.66 on December 31, 1990, for a total growth of 314 percent.

Indeed, as of year end 1990, despite the current difficulties facing the economy and the current uncertainties facing the world at large, the Dow Jones Average is 54 percent higher than its low in October 1987, following the market break at that time.

Aggregate equity market capitalization grew from $1.5 trillion in 1980 to about $3.2 trillion at the end of 1990.

Taking into account dividends and reinvestment of dividends, more than 50 million investors realized an aggregate growth of approximately $3 trillion during the last decade in the securities markets.

This growth has been a major positive factor in the strength of the overall U.S. economy and has helped to provide capital for businesses from coast to coast, as well as for State and local governments.

Indeed, even in 1990, the U.S. equity security markets, while having what was, by many measures, a less-than-satisfactory year, still outperformed their major foreign competitors.

The Dow Jones average declined approximately 4.3 percent during 1990. By contrast, the London stock market average declined about 11.5 percent during 1990, and the Nikkei average in Japan declined almost 40 percent during the year.

Among the major markets, only Hong Kong did better, in terms of local currency, than did the U.S. market during 1990.

While the equity securities markets continue to be the best place for long term investment, the last few years have not been as kind to the U.S. securities industry. The industry's operating results have been very poor since October of 1987, with an average pretax return on equity during 1988 and 1989 of about 7 percent.

While it is too early for us to have final results for the entire year 1990, certainly all the estimates that we have seen, as well as the annualized data running through the third quarter, suggest that the industry, as a whole, may well have lost money in 1990.

That result would make 1990 the worst year, in terms of earnings, since 1973.

The adverse overall results of the industry reflect sharp declines in virtually every major sector of the business.

Commission revenue on brokerage transactions, which historically has been one of the largest sources of securities industry revenue, has been shrinking in recent years, in part due to the continued withdrawal of individual investors from the marketplace.

Aggregate commission revenues fell by another 11 percent in 1990.

Underwriting revenues also declined, falling 20 percent in 1989 and another 20 percent in 1990. This factor alone cost the industry almost $2 billion in revenue in 1990, compared with the reduced levels of 1989.

This decline in underwriting revenues reflects, in part, a net redemption of equities, a very disturbing trend, that has removed almost $500 billion in equities from the market since 1984.

Merger and acquisition activity also declined in 1990 by approximately 50 percent.

One response to these trends has been an increase in the degree of reliance of some firms on principal activities, either in trading or investment. And by "principal activities," of course, I mean activities in which the firm, itself, takes a proprietary position, using its capital to putting its capital at risk in a particular transaction, rather than executing a transaction on behalf of others.

The Commission is watching this trend for a greater percentage of revenue stemming from proprietary activities very carefully because this shift may expose securities firms to risks that are different in character and greater in magnitude than the risks that they have traditionally undertaken.

Among other responses, the Commission is in the final stages of amending our capital regulations to adjust current minimum capital and early warning requirements, to raise those levels with respect to firms in which principal activities are the main profit center.

In order to improve its profitability, the industry has been cutting costs. Unfortunately, many of the industry's largest costs, such as office leases and investments in computer and communications equipment, cannot be reduced quickly.

As a result, expenses have not declined as quickly as revenues, even though aggregate securities industry employment is down by 45,000 jobs from its pre-October 1987 high.

Another has been an effort to decrease total industry capacity. Since the end of 1986, the total number of New York Stock Exchange member firms has declined from 611 to 525, and the total number of NASD member firms has declined from in excess of 6600 firms to slightly over 5800 firms.

Profitability, however, is not the only measure of the health of the U.S. securities industry.

A complete picture of the health of the securities industry must include a number of factors, including the strength of capital reserves and other balance sheet items, the reliability of accounting information, management capabilities, and the strength of the long term business fundamentals.

Viewed from that broader perspective, the industry is considerably stronger than earnings might suggest.

As of the end of the third quarter, for example, total industry capital was over $36 billion.

Indeed, as of the end of the second quarter in 1990, the industry had more than $13.5 billion in capital in excess of regulatory requirements, and that amount came after deducting $13 billion in illiquid assets and $7.9 billion in what we call "haircuts" for risky positions.

This capital position provides a very strong foundation for long-term stability and, ultimately, for long term growth.

Indeed, in recent years, capital has been flowing into, not out of, securities firms.

In 1990, diversified parent holding companies contributed nearly $1 billion in new capital to their broker dealer subsidiaries, and purchased $2 billion more in risky assets from them; potential loss positions were taken over by parent firms and taken out of the brokerage subsidiaries.

The net result was almost $3 billion in financing made available to the subsidiary securities firms.

Because of what are, in my opinion, utterly unnecessary and counterproductive restrictions on the ownership of banks by diversified firms, similar to those that are permitted to own securities firms, this extremely important source of capital is not available to our banking industry today.

One of the Commission's primary objectives is, of course, to encourage the stability of the U.S. market and to protect investors from the sudden failure of a brokerage firm.

The Commission accomplishes this purpose through a combination of stiff financial responsibility rules and careful regulatory oversight, both of which play an important role in stabilizing the industry's financial condition during periods of economic uncertainty.

For example, under the Commission's rules, the securities positions of every registered broker dealer must be marked to their market value, each and every day. Thus, unlike the banking industry, the capital of securities firms does not include unrealized losses on securities or other assets.

This rule prevents a broker dealer or a mutual fund from juggling its books to hide losses.

It also ensures that regulators and investors alike can make regulatory and investment decisions based on the real value of the broker dealer's assets, not on wishful thinking in which inconvenient losses are simply disregarded for purposes of capital calculations.

The Commission also requires broker dealers to maintain adequate levels of net capital.

Net capital is defined strictly to exclude 100 percent of the value of assets that are illiquid, and to exclude a portion of the value of other proprietary securities positions in order to reflect possible market risk, or risk of illiquidity.

Fully paid customer securities must be segregated in a separate account by the broker dealer. They may not be encumbered by the firm, and they must be available for distribution to the customer upon request.

The Commission's financial responsibility rules, of course, cannot and should not prevent securities firms from failing.

When securities firms become insolvent, as some inevitably will in an intensely competitive industry, the goal of the Commission is to minimize the cost of failure to customers and to the Securities Investor Protection Corporation fund, if it should become involved.

One way the Commission accomplishes this purpose is to force broker dealers to shut down their operations when they fall below minimum net capital levels.

In the securities industry, there is simply no such thing as regulatory forbearance.

If a broker dealer cannot meet its minimum net capital requirement, then it must immediately cease to do a securities business; no ifs, no ands, and no buts about it.

Because we measure this condition every day, based on up-to-the-minute valuations, we are usually able to intervene while net

worth is slightly positive, not after it has become massively negative.

This hard line is intended to make certain that, if the broker dealer fails, the cost to customers and the SIPC fund is kept to an absolute minimum, preferably, zero.

Even if a securities firm is insolvent, the Commission attempts to wind down its operation swiftly and without involvement of the SIPC fund at all, if possible.

Frequently, the Commission can do this by transferring the broker dealer's customers to another, better capitalized broker dealer without putting the failing broker dealer through a SIPC insolvency proceeding.

For example, both Drexel Burnham Lambert and Thomson McKinnon Securities were liquidated without intervention by SIPC. With the help and supervision of both the Commission and the New York Stock Exchange, these two firms transferred almost a half million customer accounts, with a value totalling about $15 billion, to other broker dealers, all without intervention by the SIPC and without loss to customers.

At least in part due to the early closure policies, based on current market values, and strict creditor discipline, the total number of broker dealer failures that SIPC has been required to handle historically has been much much less than the number of bank and thrift failures handled by the bank insurance funds.

For example, since 1980, more than 2000 bank and thrift failures have been handled by the FDIC and the FSLIC, while only 82 securities firms went through SIPC insolvencies during that period.

The combined effect of these actions has minimized the cost to the SIPC fund of broker dealer failures. SIPC has now handled over 200 broker dealer failures since its inception in 1970, at an average cost of less than $1 million per failure.

Moreover, the largest single payout in SIPC history was only $32.5 million.

Despite the successful record to date, the Commission hopes to see the SIPC fund, which now totals a record of almost $600 million, continue to grow.

For tens of millions of U.S. investors, the investment management industry is now the critical link to the securities markets.

One in four American households participates in the U.S. securities markets through approximately 2500 mutual funds, which have 58.2 million shareholder accounts, and $1.1 trillion in assets.

If closed end funds and unit investment trusts are included, the total asset figure rises to more than $1.3 trillion.

The principles of safety and soundness, fundamental to the Investment Company Act, provide enormous protection to mutual fund customers without relying on any Federal insurance.

Among other things, the Investment Company Act requires the safekeeping of fund assets, limits leveraging, and prohibits self-dealing.

The Act also requires that 40 percent of a fund's board be composed of independent directors.

In addition, most mutual funds must mark their portfolios to market every day and stand ready to redeem their shares at market value, each and every business day.

In 1989, the mutual fund industry grew by almost $172 billion, the second largest annual increase on record.

Through November 1990, the industry grew by another $96.3 billion.

The Investment Company Institute has predicted that mutual fund assets will grow at a rate of just in excess of 12 percent in the 1990's, with mutual fund assets reaching $3.5 trillion by the year 2000.

Money market funds now account for almost 50 percent of total mutual fund assets.

In 1984, there were 329 money market mutual funds with assets of just over $200 billion, held by 13.5 million shareholders.

Today, there are approximately 725 money market funds, with more than $494 billion in assets and over 21 million shareholder accounts.

Many investors have come to view money market funds as alternatives to bank checking and savings accounts, despite the lack of Government insurance.

Customers and investors in those funds should be aware that they are not Government insured. They do represent a different investment choice than depositing funds in a bank or other depository institution.

Good investment returns, the ease with which investments can be made, features such as check writing, and a very solid track record of paying back $1 for every dollar invested have contributed to investor confidence in money market funds over the past 15 years.

This solid track record is not an accident. The Commission continues to monitor money market funds carefully.

Recently, following several defaults in the commercial paper market, the Commission proposed amendments to rules relating to these money market fund investments to reduce further the risks to which a money market fund could be subject.

I expect the Commission to approve final amendments to the money market fund rules in the very near future.

In conclusion, the Commission is, of course, concerned about the reduced profitability of securities firms in recent years.

Nevertheless, our securities industry continues to demonstrate its competitiveness internationally, and its creativity, while providing the capital for future economic growth.

Huge capital reserves, rigorous oversight in accounting requirements, and strong discipline by the market have kept the securities industry stable.

As a result, investors should feel confident in investing long-term savings in the securities markets, and in the future economic health of America.

Those markets have historically provided savers and investors the very best returns without any need for taxpayer subsidies or safety nets.

Hopefully, as Congress considers proposals to reform the U.S. financial system, these important, and in many ways, highly successful, attributes of the securities markets will be utilized even more broadly than they are today.

Thank you very much.

[The complete prepared statement of Richard C. Breeden follows:]

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE STATE OF THE SECURITIES INDUSTRY

BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE
ON BANKING HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JANUARY 8, 1991

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE STATE OF THE SECURITIES INDUSTRY

BEFORE THE SECURITIES SUBCOMMITTEE OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JANUARY 8, 1991

Chairman Dodd and Members of the Subcommittee:

It is my pleasure to testify today concerning the state of the United States securities industry.

As a preliminary matter, I would like to emphasize that an understanding of the "state of the U.S. securities industry" involves many factors. These include current earnings, the strength of capital reserves and other balance sheet items, the reliability of accounting information, management capabilities, the strength of long-term product demand, the likelihood of unknown sudden problems, and other factors. Measured in terms of current profits, the securities industry has just finished one of its worst years in recent memory. However, the overall condition of the securities industry is considerably stronger than current earnings would indicate.

The securities industry today has near-record levels of capital, and the reserves of the Securities Investor Protection Corporation fund are at an all-time high. In addition to having high levels of stated capital, the securities industry has capital reserves that are real. As this Committee knows, the securities held by broker-dealers are marked to reflect market value every single day. Because the value of these positions is also further discounted to reflect market and liquidity risk, the Commission has a high degree of confidence in these capital levels.

While the final year-end operating results are not yet available, it is quite possible that the securities industry as a whole lost money in 1990. Whether the final result is a slight profit

or a slight loss, it is very likely that the results for 1990 will prove to be the worst in many years. In addition, this condition comes on top of relatively poor industry profitability since the market events of October 1987.

Although a decline in profits is not unusual considering the level of activity of the overall economy, this downward trend in profits is cause for concern. For the longer term, maintaining strong financial condition must involve returning to healthy profitability. Either revenues must be increased, or firms will have to take further steps to reduce expenses. This could involve the reduction of firms' overhead by shrinking their office networks, exiting particular areas of activity, further reducing payroll costs, or other steps. Ultimately, some firms could decide to combine as a step toward reducing costs. Ironically, at a time when many are suggesting bank entry into the securities business, the existing industry is under pressure to shrink, not to grow.

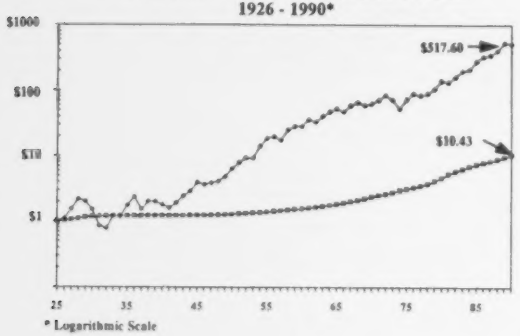
The U.S. Securities Industry During the 1980s

The 1980s were years of phenomenal growth for investors in the U.S. securities markets. From January 1, 1980 to December 31, 1989, the Dow Jones Industrial Average ("DJIA"), the most widely followed indicator of the U.S. stock market's movements, rose 228%, and the broader Standard & Poors 500 Stock Index (the "S&P 500") rose 227%. The DJIA grew from 838.74 on January 1, 1980 to 1895.95 on December 31, 1986 to 2633.66 on December 31, 1990. Aggregate equity market capitalization during the decade grew from $1.5 trillion to about $3.2 trillion at the end of 1990. Taking into account dividends, reinvestment of dividends, and stock repurchases, the "profit" to investors during this period could be as much as $3 trillion. This growth not only benefitted the tens of millions of American investors, but also provided important strength to the U.S. economy.

Investment in equity securities remains by far the best source of return for ordinary Americans' savings for the long term. For example, an investor who put $100 in Treasury bills in 1926 would have $1,043 today. However, if the same person had invested $100 in the stocks that comprise the DJIA in 1926, even after the crash of 1929 and the "breaks" of October 1987

and October 1989, that person would have $51,762 today.

Total Returns of Common Stock and T-Bills
1926 - 1990*



* Logarithmic Scale

Indeed, even in 1990, the U.S. equity security markets outperformed their major foreign competitors. The DJIA declined only 4.3% during 1990. The London stock market declined 11.5% during 1990, and the Japanese market declined 38.7% during the year. Among the major markets, only Hong Kong did better in local currency terms than the United States during 1990.

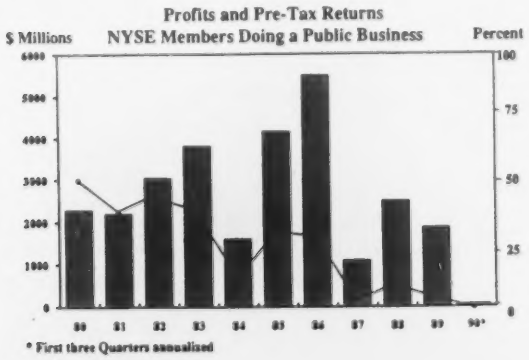
Although investors were well served by the U.S. securities markets during the last ten years, the 1980s were a rollercoaster decade for the United States securities industry.[1] From 1980 through 1986, industry volume reached record highs. The average number of shares traded on a daily basis on the New York Stock Exchange ("NYSE") rose from 44.9 million to 141.0 million. Volume on the National Association of Securities Dealers Automated Quotation

[1] Unless otherwise specified, "industry" figures herein are figures for New York Stock Exchange member firms doing a public business. These firms have 84% of total industry assets and 76% of total industry capital, and are responsible for 77% of total industry revenues.

("NASDAQ") system, meanwhile, rose from 26.5 million shares per day to 113.6 million shares per day.

In addition to the growth in brokerage volume, there was strong growth in the volume of securities offerings. This growth was most pronounced in the markets for debt securities. New issuances in the market for straight corporate debt skyrocketed from $35.2 billion during 1980 to $119.4 billion during 1986. Issuances in markets that had barely existed prior to the 1980s, meanwhile, such as asset-backed bonds and high-yield debt securities, grew rapidly as well. New issuances of asset-backed bonds, for example, rose from $0.5 billion in 1980 to $68.4 billion in 1986. Issuances of high-yield debt securities grew from $4.3 billion to $40.8 billion over the same period. While offerings of debt securities were more active, underwritings of equity securities grew from $16.0 billion in 1980 to $57.1 billion in 1986.

The growth in brokerage volume, new offerings, merger and acquisition and other transaction fees fueled tremendous profits for the securities industry. Industry pre-tax return on equity was 49.2% in 1980, 13.2% in 1984, and 28.5% in 1986. From 1980 to 1986, the average pre-tax return on equity for the securities industry was 33.4%.



Lured by those returns and the competitive realities of international securities markets, new capital flooded into the securities industry. Total industry capital rose from $6.8 billion in 1980 to $30.1 billion in 1986 and $36.1 billion by the end of September 1990.

In 1987, however, the industry reached a turning point. Although the DJIA reached a then-record high in August, the nation's securities markets experienced an extraordinary surge of volume and price volatility in the month of October. During the week of October 5, the DJIA declined by 158.78 points, followed by a further descent of 235.47 points during the week of October 12. Then, on October 19, 1987, the DJIA plummeted 508.32 points. By its mid-day low point on October 20, the DJIA stood at 1708.70, down 35.3% from where it had closed a mere 18 days earlier.

Demonstrating enormous resiliency and underlying strength, the market was able to rebound from the 1987 collapse in prices. As of December 31, 1990, despite substantial uncertainty about potential hostilities in the Persian Gulf, the state of the economy generally, and serious concerns regarding particular sectors such as commercial real estate, the DJIA closed at 2633.66, 54% higher than its low in October 1987 of 1708.70. Total market capitalization, as noted above, has also continued to increase, to a total of about $3.2 trillion as of the end of 1990.

Though the value of equity securities has more than recovered from October 1987, the securities industry has experienced a series of adverse developments in recent years. Indeed, almost every major area of activity has declined since 1987. For example, volume on the NYSE in 1990 was down approximately 17% from 1987. Volume on the NASDAQ was down approximately 12% over the same period. Compounding the decline in trading volume has been a significant decline in commission rates. For example, institutional commission rates have been reduced from approximately 12 to 15 cents per share in 1980 to often less than five cents per share today. Total securities firm revenue from brokerage transactions has thus fallen substantially.

Initial public equity offerings fell from 247 offerings for $13.8 billion in 1989 to 209 offerings for $10.1 billion in 1990. Equity offerings by seasoned issuers fell from $15.2 billion

in 1987 to $9.3 billion in 1989 to $9.0 billion in 1990. There were 41% fewer private placements of both debt and equity during the first half of 1990 as compared to the first half of 1989. Total public debt offerings rose, however, from $278.3 billion in 1989 to $293.2 billion in 1990. Overall, revenues from securities offerings have also fallen sharply, from $5.2 billion in 1987 to an annualized[2] $3.3 billion in 1990.

One response to these trends has been an increase in the degree of reliance of some firms on principal activities for a larger percentage of revenue. The Commission is watching this trend carefully because this shift may expose securities firms to risks that are different in character and greater in magnitude than the risks that they have traditionally undertaken. Among other responses, the Commission is in the final stages of amending its capital regulations to adjust our current minimum capital and "early warning" requirements with respect to firms in which principal activities are the main profit center.

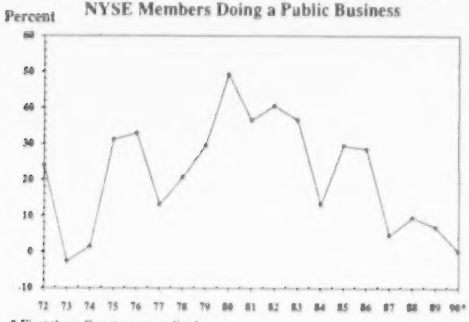
Profitability

From 1987 to 1989, the pre-tax return on equity of the securities industry averaged only 7%, and in each year was less than the worst year from 1980 to 1986. In 1990, the securities industry's profitability deteriorated even further. For the first three quarters of 1990, the industry's aggregate pre-tax net income was only $34 million. Pre-tax return on equity for the first three quarters of 1990 was 0.2% on an annualized basis. As the following table shows, return on equity has not been this low in the securities industry since 1973-74.

---

[2]Unless otherwise stated, "annualized" figures are based on the first three quarters of 1990.

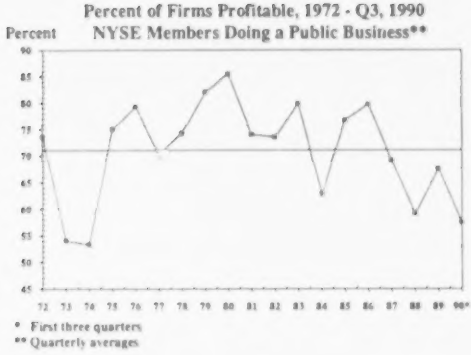
Pre-Tax Return on Equity Capital, 1972 - Q3, 1990
NYSE Members Doing a Public Business



* First three Quarters annualized

The trend in profits continues to head downward. The industry has had only had six losing quarters since 1975, and three of them have occurred in the last four quarters -- the last quarter of 1989, the first quarter of 1990, and the third quarter of 1990. If the securities industry experienced a loss in the fourth quarter of 1990, it is likely that pre-tax net income will be negative for the year. In any event, the industry's pre-tax net income will almost certainly fall far short of the $1.8 billion profit the industry earned in 1989 and the record $5.5 billion earned in 1986.

As might be expected, the fall-off in industry profitability has been felt by a large number of U.S. securities firms. On average, in each of the last 17 years, fully 71% of securities firms have operated profitably. Since October 1987, however, that percentage has fallen dramatically. As the next table shows, only 57.5% of securities firms were profitable in the first three quarters of 1990. Less than half of the industry's members were profitable in the third quarter.



The results of the largest U.S. securities firms generally mirrored that of the industry as a whole. As of the end of the third quarter of 1990, the largest 13 NYSE member firms (measured by capital)[3] reported aggregate pre-tax losses of $15 million, which translates into an average annualized return on equity of -0.21%.

The poor profitability performance has not been felt equally by all sectors of the securities industry, however. From 1987 through 1989, for example, large investment banks had an average annual return on equity of 12.2%, and discount brokers 13.1%. National full-line firms, in contrast, had an average return on equity of -0.1% during that three-year period. These trends have continued during the first nine months of 1990, as large investment banks had an

[3]These firms are Bear Stearns & Co., Inc., Dean Witter Reynolds Inc., The First Boston Corporation, Goldman Sachs & Co., Inc., J.P. Morgan Securities Inc., Kidder Peabody & Co. Inc., Merrill Lynch Pierce Fenner & Smith Inc., Morgan Stanley & Co. Inc., PaineWebber Inc., Prudential-Bache Securities Inc., Salomon Brothers Inc, Shearson Lehman Brothers Inc., and Smith Barney Harris Upham & Co.

average return on equity of 10.6%, discount brokers 19.0%, and national full-line firms -7.9%, on an annualized basis.

The profitability data of different industry sectors suggest that well-run, specialized firms that identify and exploit particular market sectors -- such as investment banks, discount brokers, and regional broker-dealers -- may be able to compete effectively with or even out-compete larger, more diversified, nationwide firms. This may suggest that the business strategy of building "financial supermarkets" has not to date proven universally successful. Specialized firms with an area of strong expertise and low costs may be proving more effective market participants than national full-line firms.

Revenues and Expenses

Although the industry's net income fell dramatically from 1987 through 1989, total industry revenue continued to rise during that period. The data from the first three quarters of 1990, however, suggest that total industry revenue will decrease significantly for the full year.

As noted above, the effects of the October 1987 Market Break were felt first, and most dramatically, in the area of commission revenue. Total commission revenue in 1988 declined by almost a third, from $12.6 billion to $8.8 billion. While commission revenue bounced back to $10.2 billion in 1989, annualized commission revenue for 1990 was only $9.1 billion.

Commission Revenues, 1973 - Q3, 1990
NYSE Members Doing a Public Business

* First three quarters annualized

Securities underwriting revenue remained relatively stable in 1988, but underwriting revenue declined by 20% in 1989. It appears that underwriting revenue fell even further in 1990. If the results from the first three quarters of 1990 are annualized, underwriting revenue in 1990 declined by another 20.2% to $3.3 billion. This would be the lowest level since 1984.[4]

It also appears that "other securities-related revenue," which is now the largest component of securities industry revenue,[5] declined significantly in 1990. This category, which includes such diverse activities as interest from repurchase agreements, merger and acquisition-

---

[4] The prime growth area for underwriting revenue related to the emergence of a new product, index warrants. Over 78 million index warrants were issued, and trading in index warrants amounted to 13.85% of the Amex's total volume in 1990.

[5] The relative size of other securities-related revenue can be deceptive, however, because interest income from matched repurchase transactions frequently is reported on a gross, not a net, basis. The offsetting cost is then included in expenses as interest expense, which explains why interest expense is also the largest expense category.

related fees, and private placement fees, decreased by 14.4% in 1990, based on the first three quarters' results.

The only industry revenues that rose in 1990 were revenues from trading and investment activities. Annualized revenues from these activities were $13.1 billion, higher than any previous year except for 1986. Thus, it appears that many securities firms are becoming more dependent on principal activities, including index arbitrage, for the bulk of their profits as we enter the 1990s. Many of these activities are both risky and highly capital-intensive.

Not all principal activities have been successful, however. During the mid-1980s, some large investment banks began to facilitate acquisitions by their clients by providing them with "bridge loans" to complete such acquisitions. These very large loans were sometimes extended through the regulated entity, but more often through its immediate parent. These loans were intended to be repaid after the acquisition was completed by the proceeds from a subsequent issue of high-yield debt securities. By December 31, 1989, the ten NYSE firms willing to make bridge loans had aggregate bridge loans of $4.2 billion outstanding. In some cases these firms had made bridge loans far in excess of their capital.

As the market for high-yield debt securities collapsed following a series of issuer bankruptcies, these securities firms sought to reduce their aggregate bridge loan exposure.[6] As a result, the total volume of bridge loans outstanding fell to $2.3 billion as of November 30, 1990. There is very little new bridge lending at the present time.

Unfortunately, the decline in industry revenues has not been matched by an equivalent decline in expenses. In part, that is because many of the industry's largest costs cannot be reduced quickly. The major firms have made large investments in computer and communications equipment, which has greatly increased firm overhead levels. Leases on office space cannot be abandoned, and firms understandably are reluctant to dismiss talented staff. As a result,

[6]On September 13, 1990, Campeau Corporation and its affiliates defaulted on the bridge loans that they had received from three broker-dealer holding companies. In addition, due to the uncertainty of the creditworthiness of some of their counterparties, several broker-dealers have restructured the terms of their existing bridge loans and created reserves for potential losses.

expenses historically have tended to decline much more slowly than associated revenues. Nevertheless, in 1990 aggregate costs fell by 5.9% on an annualized basis, with every category of costs registering a decline.

Because of high fixed overhead, these cost reductions have regrettably come primarily through reductions in the size and compensation of the securities industry work force. In 1990, total employee compensation, the largest component of industry expense other than interest expense, fell to $18.1 billion, down 11.6% from its 1987 level. As of June 30, 1990, aggregate employment in the securities industry is now down by more than 45,000 jobs, 18% lower than its pre-October 1987 high. Despite the tremendous costs and personal pain associated with these layoffs, however, further cuts may occur.

The decline in revenues has left the U.S. securities industry with a great deal of overcapacity. In part, that is because the industry historically has been prone to developing excess capacity during boom periods, only to shed that capacity when business slackens. As profitability and volume have declined since 1987, the industry has been contracting in an effort to reach a more efficient size and structure.

One result of this process has been the reduction in the number of firms engaged in the securities business. Since 1986, the number of NYSE member firms has declined in each year, from 611 at the end of 1986 to 525 in October 1990. Similarly, the number of NASD member firms had declined from 6658 to 5827 during the period from the end of 1986 to the end of 1990. Drexel Burnham Lambert Inc., one of the nation's largest securities firms, was forced into liquidation proceedings and left the securities business during 1990. However, though the number of firms has been declining, the overall number of failures of securities firms has been extremely small compared with the number of failed depository institutions. The FDIC and FSLIC handled 1266 bank and thrift failures from 1980 through 1990; SIPC handled only 82 securities firm failures in the same period.

The decline in revenues, and the consequent overcapacity problem in the securities industry, has implications for the overall restructuring of the financial services industry that

Congress is expected to undertake in 1991. Inexperienced firms without market share that enter the business are likely to lose money, at least in the short term, as existing firms fight to retain their market share. Thus, significant losses, not profits, could be the short term result of banks entering the securities business.

Effect on the Securities Industry of a General Recession

As we have discussed, the causes of the current difficulties in the securities industry date mainly from late 1987, long before the beginning of the current general economic downturn or recession. It is possible for the securities industry and individual firms to suffer losses even during a period of general economic growth, as occurred with many firms in late 1987. It is also possible for the securities industry to earn profits during a general recession. Indeed, during the last two recessions (February 1980-July 1980 and August 1981-November 1982) the average pretax return on equity for the securities industry was 32.6% per annum. One has to return to the period of December 1973 to March 1975 to find a time when there was both a general recession and substantially reduced securities industry profits. Even then, if one looks at the entire period, the industry's average return on equity was 13.3% per annum.

This is not to say, of course, that a general recession would have no effect on the securities industry. A recession would likely reduce individual interest in equity securities purchases and reduce corporate issuance of equity securities, two of the prime bases of securities industry revenues. A recession would likely lead to an increase in issuer defaults on debt, particularly junk bonds, although the total holdings by securities firms, other than Drexel Burnham, of junk bonds are now rather small, only about $2 billion. In part because of these factors, industry experts are predicting that 1991 will be another difficult year for the securities industry. If past recessions are any guide, however, we can expect an increase in industry profits before the end of the recession. Indeed, in past recessions stock prices have generally increased appreciably during the last three months of the recession.

International Competition

The United States securities industry's profitability problems have also been affected by the tremendous increase in international competition in the securities business. Most major foreign securities firms now have U.S. affiliates and/or engage in business in the United States markets. In particular, seven of the 100 largest U.S. broker-dealers were established by foreign securities firms.[7] These firms do not yet appear to be profitable in the U.S. market. In the third quarter of 1990, for example, they lost an aggregate of $10.1 million after taxes, for an after-tax return on equity of -1.3%. Nevertheless, these firms have over $750 million in net capital, and they have invested even greater economic and human resources in their effort to compete successfully in the U.S. securities industry.

Until recently, the increased level of foreign competition has been accompanied by a tremendous inflow of foreign investment in the U.S. securities markets. In 1989, for example, purchases and sales of U.S. securities by foreign persons were $4.76 trillion. This was almost seven times the $707 billion in purchases and sales of foreign securities by U.S. persons. In 1990, however, foreign investment in the U.S. securities markets has fallen sharply. On an annualized basis in 1990, foreign portfolio activity in the U.S. securities markets fell 11.4% to $4.22 trillion.

The internationalization of the securities markets, of course, also has provided U.S. securities firms with new competitive opportunities. In particular, liberalized access in the United Kingdom and Japan has led U.S. firms to make major investments in those countries.

Unfortunately, the markets in London and Japan have encountered, if anything, even greater problems than those in the United States. Ever since the "Big Bang," in which the London markets were opened to the world, the securities industry in the United Kingdom has been plagued by overcapacity, and many firms that sought to establish a foothold in the London

---

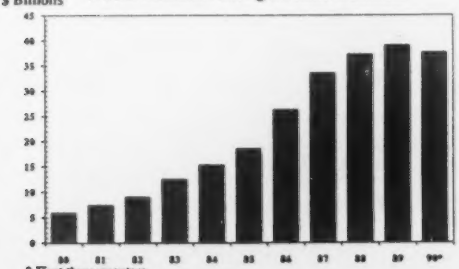
[7] These firms are Daiwa Securities America, Inc., Deutsche Bank Capital Corporation, New Japan Securities International, Inc., Nikko Securities Co. International, Inc., Nomura Securities International, Inc., SBCI Swiss Bank Corporation Investment Banking, Inc., and Yamaichi International (America), Inc.

markets have since closed their London operations. In Japan, the Nikkei 225 Stock Average fell almost 39% in 1990, and average trading volume on the Tokyo Stock Exchange has decreased from 894 million shares per day in 1989 to 507 million shares per day in 1990 (through November 30).

Industry Capital

Despite all of these difficulties, however, the United States securities industry still has a strong capital position. Total capital -- including both equity and subordinated debt -- at the end of the third quarter was $36.1 billion. As the next table shows, although the industry's total capital has not changed materially in the past two years, it is still higher than it was at year-end 1987 ($33.5 billion), and it is more than six times its 1980 level of $5.9 billion.

Capital, 1980 - Q3, 1990
NYSE Members Doing a Public Business



* First three quarters
NOTE: Figures are averages for periods

Similarly, the major markets and self-regulatory organizations remain strong and resilient. Indeed, the NYSE and the NASD have total members' equity and retained earnings of $248 million and $146 million, respectively. Moreover, both the NYSE and the NASD have made multimillion dollar commitments to upgrade their computer and communications systems capacity since 1987. Accordingly, the exchange and over-the-counter markets in the United States are well-positioned to compete internationally and to ensure fast and efficient execution of public investors' orders. Like the rest of the securities industry, the 13 largest NYSE members have a solid capital foundation. These firms have total capital of $25.3 billion, of which $15.4 billion is equity capital and $9.9 billion is subordinated debt.

The securities industry's capital position has been strengthened through the affiliation of many large broker-dealers with large, diversified, well-capitalized parent holding companies. Unlike banks or thrifts, securities firms are permitted to be affiliated with commercial enterprises, regardless of the lines of business in which they are engaged. Indeed, the 14 largest broker-dealer holding companies have total assets of over $1 trillion. In many cases, these firms have proven to have the resources necessary to support their broker-dealer subsidiaries when they encounter financial turbulence.

The value of these affiliations was demonstrated in 1990. During the course of the year, parent holding companies bolstered their broker-dealer subsidiaries' capital position, either by direct capital infusions or by purchasing risky or illiquid assets from the broker-dealer. For example, American Express contributed $450 million in new capital to Shearson Lehman Hutton, and $300 million more to Shearson's immediate holding company, an American Express subsidiary. General Electric purchased $750 million of high-yield bonds and bridge loans from Kidder Peabody. Credit Suisse contributed $300 million in capital to, and purchased a $2 billion bridge loan from, First Boston's immediate parent, which in turn reduced its bridge loan exposure by over $700 million by, among other things, transferring three bridge loans to a new entity that it owns jointly with Credit Suisse. Prudential Insurance Company provided $2

million in capital to Prudential-Bache's immediate parent and bought $600 million in bridge loans from a Prudential-Bache affiliate.

While some parent holding companies provided valuable support to their subsidiary broker-dealers, others have created exposures for their subsidiary broker-dealers. The Drexel failure, for example, began at the holding company level, and then spread to the broker-dealer when the parent sought to withdraw capital from the broker-dealer to resolve its own financial difficulties. In addition, it appears that some broker-dealers have transferred some of their riskier and non-traditional principal activities to their parent holding company or another affiliate. In so doing, these broker-dealers reduced their overall risk exposure, but at the same time prevented the Commission from overseeing these activities to ensure that they would not have a material financial impact on the broker-dealers' financial condition.

The Market Reform Act of 1990 has given the Commission new authority to monitor, on a consolidated, world-wide basis, the activities of broker-dealers' parents and affiliates in holding company structures. Such authority will enable the Commission to assess the potential exposure of regulated broker-dealers to adverse occurrences or circumstances affecting the broker-dealers' related entities. With such information, the Commission will be in a better position to plan possible responsive actions in the event problems at the holding company level threaten to cause a failure of the subsidiary broker-dealer. The Commission staff is in the process of drafting proposed rules to implement the "risk assessment" provisions of the Market Reform Act, and we expect those rules to be published for public comment sometime in the first quarter of this year.

The industry's strong capital position is buttressed by the Commission's net capital requirement, which mandates that each broker-dealer must maintain liquidity in excess of liabilities in order to cover potential market and credit risk associated with the broker-dealer's assets.[8] By requiring broker-dealers to maintain liquid assets sufficient to satisfy their

[8]The Commission's rule provides two alternative methods for computing compliance with the net capital requirement. Under the basic method, a broker-dealer must have net capital equal to at least 6 2/3% of aggregate indebtedness (defined to exclude liabilities that are adequately collateralized by an asset). Under the alternative method of computing net capital, a broker- dealer must maintain net capital equal to at least 2% of its customer-related receivables.

obligations, the net capital requirement provides a protective cushion without drying up the liquidity necessary to ensure the orderly operation of the securities market.

In addition to the basic net capital requirement, the net capital rule ensures the continued liquidity of broker-dealers by requiring them to mark their securities positions to market value, instead of carrying those positions at historic cost. Requiring broker-dealers to use market values for securities positions ensures that regulators and investors alike receive meaningful, up-to-date data by which to assess the real economic values and risk exposures of broker-dealers. At the same time, the use of market-based accounting protects creditors and the Securities Investor Protection Corporation ("SIPC") fund by ensuring that, if a broker-dealer fails, the value of its assets will not disappear during liquidation proceedings in a puff of accounting smoke.

Even after securities positions are marked to reflect market value, the net capital requirement affords further protection by providing that a broker-dealer may not include in its net worth calculation certain assets not readily convertible into cash. In addition, the broker-dealer must deduct a certain percentage of the market value of all proprietary securities positions. These percentage deductions, known as "haircuts," are intended to reflect the actual liquidity of the broker-dealer's proprietary positions by providing a cushion for possible future market losses in liquidating the positions.

As of June 30, 1990, after deducting illiquid assets of $13 billion, industry members were required to take cumulative deductions of $7.9 billion for securities positions ($6.8 billion by the 13 largest NYSE members). After these deductions, these firms had cumulative liquid capital of $14.7 billion, far in excess of the $1.1 billion that constituted required minimum net capital.

If a broker-dealer fails to meet its minimum net capital requirement, it immediately must cease to conduct a securities business. By requiring a broker-dealer to shut down its securities operations as soon as its net capital falls below the mandated amount, the net capital requirement reduces the cost of securities firm failures to creditors. It also reduces the likelihood that the

SIPC fund will experience any loss.

In addition, the net capital rule contains early warning provisions, specifying levels below which a firm's net capital should not fall.[9] When a broker-dealer's net capital drops below the early warning levels, a broker-dealer must notify the Commission and must refrain from paying dividends or withdrawing equity capital in any form to pay shareholders or partners. The rules of some self-regulatory organizations also contain provisions restricting a broker-dealer's securities business when its net capital reaches early warning levels. These Commission and self-regulatory restrictions are designed to prevent a broker-dealer from depleting its capital to the point that it cannot satisfy its minimum net capital requirement.

Although the net capital requirement has worked well to date, the Commission is taking steps to enhance its effectiveness. For example, the Commission has proposed an amendment to its net capital rule that would require a broker-dealer to give prior written notice to the Commission and the appropriate self-regulatory organization of its intention to disburse more than a specified percentage of its capital to its parents, shareholders, and related entities. This proposal would also permit the Commission to block withdrawals that would expose the broker-dealer to an unacceptable level of financial risk. If adopted, these amendments would help give the Commission more time to take measures that may be necessary in response to the sudden withdrawal of capital from a major firm.

In addition, the Commission is considering amendments to the net capital rule to allow the Commission to prohibit withdrawals when the effect of the withdrawal is to reduce the registered broker-dealer's net capital in an amount in excess of certain percentages of the broker-dealer's haircuts on its securities positions. This additional "early warning" standard would reflect the shift of many firms toward an increased focus on proprietary positions.

The Commission is also seeking public comments on the desirability of increasing the capital requirement of firms that have minimal amounts of customer-related receivables, by

[9]The early warning level is 10% of aggregate indebtedness for firms electing the basic method, and 5% of aggregate debit items for firms using the alternative method.

basing minimum capital on the level of proprietary positions in such cases. Currently, many large broker-dealers elect to use an alternative method of computing net capital, which bases the required net capital on the level of the firm's customer-related receivables. If the broker-dealer does not carry a significant amount of those receivables, its net capital requirement may be low in relation to the degree of leverage it has attained.

The Commission's customer protection rule provides further protection in the event of a broker-dealer insolvency by requiring broker-dealers to have possession or control of all fully paid and excess margin securities[10] of customers and by prohibiting broker-dealers from using customer free credit balances to finance their own inventory positions, fixed assets or operating expenses. All customer fully-paid and excess margin securities are required to be maintained free of all claims or liens.

As a result of the Commission's regulatory program, the Commission frequently has been able to wind down the operations of a failing broker-dealer without putting the broker-dealer or its customers through the time and expense of a SIPC liquidation. The most recent and most vivid example involved Drexel. When Drexel's holding company filed for bankruptcy in 1990, the Commission worked with Drexel and other regulators to close its securities operations and to transfer remaining customer accounts and securities positions to other broker-dealers. This entire program was completed without any cost to the SIPC fund or the U.S. taxpayer.

In addition to the successful handling of the Drexel situation, the Commission and the self-regulatory organizations have wound down the operations of many other broker-dealers without SIPC intervention. For example, Thomson McKinnon Securities Inc. ("TMS") shut its doors without a SIPC liquidation. With the help and supervision of the Commission and the NYSE, TMS transferred over 450,000 customer accounts with property totalling approximately $10 billion to other broker- dealers.

---

[10]Generally speaking, excess margin securities are the portion of securities bought by a customer on credit that are in excess of the amount of the securities that the broker-dealer may use to finance the customer's purchase (*i.e.*, the margin securities).

The State of the SIPC Fund

SIPC was created by Congress pursuant to the Securities Investor Protection Act of 1970 to provide protection to customers of broker-dealers, and thereby to promote investor confidence in the nation's securities markets. SIPC accomplishes this goal by ensuring that customers of SIPC members receive back their cash and securities in the event of a SIPC member's liquidation. SIPC does not protect a customer against the risk that securities may decline in value during liquidation.

SIPC is a non-profit membership corporation of which all registered broker-dealers, with some limited exceptions, are members. Although expressly not a governmental entity, five of SIPC's seven directors are appointed by the President. Three of the five are from the securities industry, and two are from the general public. The President designates the Chairman and Vice-Chairman from the two public directors. Of the remaining two directors, one is appointed by the Secretary of the Treasury and one is appointed by the Federal Reserve Board from their respective staffs.

SIPC protects each customer up to $500,000 for claims for cash and securities, except that claims for cash are limited to $100,000 per customer. Some broker-dealers also offer privately- arranged insurance coverage for securities above SIPC limits to $5 million or more.

Under the statute, SIPC must file with the Commission proposed rule changes, which require Commission approval, and proposed by-law changes, which are effective thirty days after filing unless disapproved by the Commission. The Commission may require SIPC to adopt, amend, or repeal any by-law or rule. For reasons that are not entirely apparent, however, the SEC is not represented on the SIPC board.

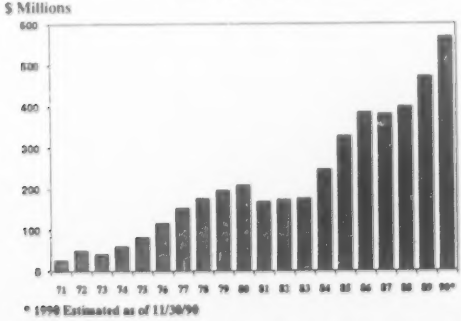
SIPC is funded by assessments on SIPC members as set by the SIPC board as a by-law amendment after consultation with the self-regulatory organizations.[11] Under the statute, SIPC may set assessments at up to 1/2 of one percent of securities revenues of SIPC members. In

[11] SIPC is also funded by interest on investments of the SIPC fund.

addition, the statute provides that SIPC may increase the assessment to a full one percent of securities revenues if it finds that such assessment will not have a material adverse effect on the financial condition of its members or their customers. The present SIPC assessment is 3/16 of 1% of securities revenues.

The SIPC fund appears to be well-capitalized in comparison with any reasonably foreseeable broker-dealer failures. As of November 30, 1990, the SIPC fund totalled $567.2 million of cash and U.S. government securities. This was its highest level since SIPC's inception in 1970. As the next table demonstrates, the value of the fund has been increasing steadily over time.

Size of SIPC Fund



* 1990 Estimated as of 11/30/90

In addition, SIPC has access to a $500 million line of credit established by SIPC with a consortium of banks. SIPC has the statutory authority to borrow up to $1 billion from the United States Treasury Department, through the Commission. As a result, a recent study[12] concludes that SIPC has sufficient resources and liquidity to handle multiple broker-dealer

[12]Deloitte & Touche, Special Study of the SIPC Fund and Funding Requirements, October 8, 1990. The Special Study used a very conservative "worst case analysis" which we believe substantially overstates the SIPC advances likely required in liquidating a large broker-dealer.

failures, including the unlikely event of a large broker-dealer failure. For the future, the Commission would like to see the size of the fund continue its recent satisfying growth.

The number of broker-dealers that must be liquidated through SIPC has always been very small in comparison to the number of bank or thrift insolvencies. In part, that is a function of tough capital standards, as well as the fact that broker-dealers are shut down quickly when they fall below mandated capital levels. Thus, since its creation in 1970, SIPC has handled only 219 broker-dealer insolvencies. By way of comparison, over 1200 bank and thrift failures have occurred in the last ten years alone.

Moreover, because of the net capital requirement and the limitations on the use of customer funds and securities, broker- dealer failures typically cost the SIPC fund far less than bank or thrift failures cost the deposit insurance funds. From SIPC's inception through December 31, 1989, only $1.5 billion in cash and securities were distributed for accounts of customers, and only $178 million of that amount came from the SIPC fund. The remainder came from assets recovered from debtors' estates. The largest single payout in the history of SIPC was only $32.5 million. A single bank failure can, and has, cost the bank insurance fund many times that amount. As described earlier, the multi-billion dollar liquidation of Drexel had a zero cost to the SIPC.

The State of the Investment Management Industry

I would also like to discuss briefly the state of the investment management industry, which for tens of millions of U.S. investors is now the critical link to the securities markets. One in four American households participates in the U.S. securities market through approximately 2500 mutual funds, which have 58.2 million shareholder accounts and $1.1 trillion in assets. If closed-end funds and unit investment trusts are included, the total asset figure rises to more than $1.3 trillion.

The principles of safety and soundness fundamental to the Investment Company Act provide enormous protection to mutual fund customers, without relying on any federal

Senator DODD. Thank you very much, Chairman Breeden.

We appreciate your statement, and I know Senator Heinz has many questions, and I do, as well, so we'll start right in this morning, and see if we can't get through much of this in the next hour or so.

Let me begin by sharing with you an observation.

All of us on this committee have sat here over the last couple of years, and I certainly sat here, and listened to thrift regulators tell me not to worry at all; things were going to be fine, back in the earlier part of the last decade.

And, of course, we heard industry experts and others tell us the junk bond market was sound and in great shape. And then we watched it turn around and virtually collapse.

We had regulators before this committee less than a year ago, telling us that the Bank Insurance Fund was in great shape, and that we shouldn't be concerning ourselves about that at all.

We saw Drexel Burnham, which had as its chairman, a former SEC chairman, and in fact, another former SEC chairman on its board, as I recall. All of a sudden, the most closely watched securities firm in the history of the industry, almost without warning, collapsed and fell apart.

Many of us here, and I think I'm speaking for many people on the committee, are wondering where will the next shoe fall.

Now Chairman Breeden, I don't disagree with what you said. You recognize we're looking at a bad year, the worst since 1973 or 1974, and yet, as you point out, there are reasons for some degree of optimism. The industry is strong in many many ways.

I just wonder if you might share with us where you think the securities firms and market professionals parhaps are taking too many risks.

What should we in Congress be doing, where should we be focusing our attention?

If you were looking at it from that perspective, as sort of coming before us to issue some warnings, what would your priorities be? What would be on your list of items to say to Congress: here are the things you guys better watch out for?

POSSIBLE PROBLEM AREAS

Mr. BREEDEN. Well, Mr. Chairman, at the outset, let me say that it certainly has not been my objective to try and sugarcoat the situation.

The situation in terms of the earnings of the industry has been very bad. It's not been good for the last few years. And, by all indications, 1990 results were terrible in terms of industry operating earnings.

I think that focusing on that, alone, does not give a complete picture of the situation. It is important to recognize that there is a broader picture of strong capital reserves, and a process of very strong market discipline, that should make investors in the market comfortable in continuing to invest—even though there may be continuing troubles in the securities industry, and we may continue to see the kind of contraction that has occurred over the last few years in the number of securities firms.

The securities industry, perhaps not to the same degree as the banking industry, has a significant amount of overcapacity, at least at current levels of transactions and brokerage buying.

And, so, there will need to be, over time, a continued shrinkage. Either the revenues have to increase, or expenses have to continue to be cut.

From the perspective of the operating results of the industry, there are a number of firms that face a strategic challenge for the 1990's in finding a profitable part of the market to serve.

Having said that, for the investor, which is, of course, critical to the SEC, we think that the capital requirements and the accounting provisions and the very strict oversight conducted on a realistic basis every day provide protection for the investing public.

And that's a point I want to underscore.

As to the long run, I don't know that any of us has a crystal ball and can say this sector may encounter problems before another.

I think that it's important and useful for Congress to focus on the measurement tools. What kinds of information are regulators getting to help them find the problems before the problems find us.

That is one of the reasons why I've stirred up a bit of controversy in suggesting that it's high time that the accounting rules, applicable to our depository institutions, start measuring current reality, instead of what I would refer to as the "once upon a time" condition that is reflected in cost accounting.

I think we need to look to the measurement tools in making sure that, if a problem starts to grow, we find it early, and respond to it quickly, rather than letting the problem fester and grow and become more difficult to deal with.

Certainly, one can go back in 1974, or thereabouts, and make a case that there was a backlog of paperwork—that seemed to be one of the major concerns anyway—the ability of the industry to handle the paperwork.

Then, all of a sudden, we watched about 100 firms disappear, and those were only ones we knew about, that were registered.

Are we watching here, what you've suggested, in the first part of your answer, something that would evidence a cyclical problem, that this happens from time to time, and that we'll work ourselves out of it?

Or is this more of an historic change that's occurring here? Is it a restructuring going on of historic proportions?

I realize that's a hard question. Normally someone can look back with far greater ease, and draw those conclusions.

But I have a growing concern that we may be writing it off as cyclical, when in fact, we ought to be looking more seriously at the developments.

And you've suggested some of that, by some of the observations you've made about financial services reforms that we need to undertake, that this is historic change in front of us.

And, yet, after your response to my last question, I have the sense that you judge it to be more cyclical.

Mr. BREEDEN. Well, I think that there's a mixture of both.

Certainly, the securities industry has been through cycles before. The level of activity in the markets is not unrelated, and I guess it

logically shouldn't be unrelated, to the level of activity in the economy.

I think it's certainly no secret that the economy has been slowing down considerably, and that, in turn, is reflected in the level of activity in the securities markets to some degree.

So there is an element, in the operating results for the year and at any given point in time, that reflects the current business cycle, the level of the economy, and other current factors.

The risk of hostilities in the Middle East has also been another factor that has been overhanging the market for a number of months and may have had a dampening effect on the level of transactions.

So, in part, I would say that we are experiencing some cyclical factors.

In part, though, I think there are long term trends at work.

Certainly, to pick an obvious example, if the level of participation by individual investors continues to decline over time, and is replaced by a much smaller number of institutional investors, that will certainly have implications for retail-oriented firms.

Those implications are not necessarily cyclical; they may represent a long term strategic challenge for such a firm, whose basic, underlying business is eroding as customers shift their preferences to some other form of handling their savings and investments.

I think there's an element of both. Virtually every sector of the U.S. financial market, today, is in a position where we have accumulated challenges stemming out of much greater international competition, technological change, and change in the way finance itself is conducted that are not reflected in the pattern of organization of either the banking industry or the securities industry.

And to an extent, those are fundamental problems that can't be cured by bandaids and can't necessarily be cured by time. Time may make some of those problems worse, not better.

Senator DODD. I don't disagree with that.

Let me move to a specific issue, which you addressed in the last part of your opening statement. I detected a bit of backing away in reading a press account, yesterday, in the Wall Street Journal, regarding the SEC's proposals on money market funds. The headline read: "Agency mulls change in paper limit rule for money markets."

Let me address the question to you in this way.

There are approximately some 21 million investors who have invested over $450 million in money market funds. They see these funds as safe, liquid investments, much like a bank account.

Yet, over the past year, we've seen a steady stream of corporate credit rating downgradings, not to mention a growing number of defaults and bankruptcies.

Recently, there've been press reports of additional weaknesses in the commercial paper market.

As you point out, last year, the SEC proposed rules to improve investment standards for money funds, in response to several defaults by issuers of commercial paper.

And yet, as I pointed out, yesterday's Wall Street Journal reported that you felt that the Commission's initial proposal may have been too restrictive, and that the SEC intends to water down the

proposal and allow money market funds to hold a greater amount of less than top grade commercial paper.

I wonder if you might just comment on that?

TOUGHENING OF THE CURRENT RULES

Mr. BREEDEN. The Commission proposed, last year, a substantial revision and toughening of what we call rule 2a-7, which governs the investment criteria for certain money market funds, most money market funds.

And we are in the final stages of a rulemaking proceeding and have been reviewing the public comments that we received, both pro and con, about that regulation.

I don't know how the Wall Street Journal knows what we are going to end up doing, because I don't know that the Commission has yet decided what it will do, and that's something that each Commissioner has to decide, based on the public hearing record, and other factors.

I would not want to prejudge the outcome of that. I think it would not be appropriate in the rulemaking context to prejudge how the Commission will ultimately decide that regulation, although I will be extremely surprised if the result is not a substantial toughening of the current rules.

In virtually every rulemaking proposal I have seen, there are variations. And certainly, for all of our recent proposals, whether it's rule 144A, regulation S, or a number of our capital standards, there have been some modifications between the original proposal and the final rule.

That's the reason you ask the public for comment, so that you read it and hopefully learn something from it.

So I won't say that there won't be some modifications, but the end result will almost certainly be a substantial toughening of the investment standards compared with current requirements.

Senator DODD. As I'm sure you're aware, the major industry association, the Investment Company Institute, has indicated that it strongly opposes any dilution of the quality of these investments that the money market funds hold.

And obviously, you're indicating, at least by your answer, there'll be serious consequences if there were any serious major commercial paper defaults.

And so your response is really, if anything else, you anticipate a tougher rule?

Mr. BREEDEN. There is absolutely no question about that.

I don't know of anyone who has proposed a weakening of current standards. I think everyone is agreed that current standards ought to be tightened. And the question is, by how much.

There are differences of opinion in the public comment files on how much toughening should occur.

I suppose I shouldn't say that no one believes that current standards shouldn't be weakened. I'm sure out there, somewhere, is someone who would be prepared to do that.

But as your question points out, Mr. Chairman, the industry has taken a very responsible position on this issue. This is unlike some situations, when trade associations are urging to water down rules

and to make disclosure less clear, rather than more clear. In this case, the money fund industry itself has been urging that action be taken in response to some of the commercial paper defaults we've seen in the past.

So I think it's highly likely that the rules will be stiffened, and they'll be stiffened in what I hope will be an appropriate and sensitive way.

Senator DODD. Before I turn to Senator Heinz, and so I don't take up too much time here, let me ask just one last question in this round.

Do you have any difficulty with the description that our present economic condition is in a recession?

Mr. BREEDEN. No, I wouldn't take issue with that.

Senator DODD. What does the SEC, what changes are you thinking about, to address the unique problems that industry will face in a recession?

Mr. BREEDEN. Well, Mr. Chairman, we are not an agency that has responsibility for the macroeconomy, obviously. We are a regulatory agency.

The business cycle will put certain pressures on industry operating results. And in some sense, the results we've seen in 1990 may prove to have been a leading indicator of the macroeconomic conditions.

We try to respond in both good times and bad, in a similar way. We try to watch firms like a hawk. We want to know which firms are starting to get in trouble and we want to know that early.

When we find out about it, then we want to make sure that corrective action is taken so that the end result is that customers do not suffer any loss.

We don't see it as our job, or that of, frankly, the Congress, or public policy, to see to it that we maintain a given number of firms.

We may have 600 firms or we may 550 firms; that's not the objective. The objective is to make sure that the 50 million to 60 million investors can participate with confidence and with safety in the marketplace.

That requires realistic capital standards, a knowledge of what the accurate condition of firms is on an up-to-the-current-time basis, and a willingness to see firms closed down when they can't raise the capital they need to operate safely.

Senator DODD. Senator Heinz.

Senator HEINZ. Mr. Chairman.

Chairman Breeden, in my opening statement I noted that during the 1980's the securities industry was affected by dramatic developments including institutionalization, internationalization, and financial innovation.

If that is an incomplete, but general summary of what happened during the 1980's, what do you see will be the major trends of similar proportion and significance, affecting the industry in this new decade?

Mr. BREEDEN. Well, I think each of those three trends are likely to continue. They probably predated the 1980's; certainly internationalization in the securities markets has been growing substantially for a considerable period.

Institutionalization has been a factor since at least the late 1960's.

Innovation has been a hallmark of the securities industry since the first meeting under the buttonwood tree on Wall Street.

So I think that those trends are certainly likely to continue.

Senator HEINZ. What new developments might we expect?

When I say, developments, obviously, there was a major increase in innovation, brought about by computerized forms of trading in the 1980's.

The so-called big bang in Europe kicked off an acceleration of internationalization. None of the trends I've mentioned are absolutely new.

But I mentioned them because, in the 1980's, there were major increases in the pace and impact of that change.

So I'm really asking you to look ahead to the next 10 years and say, well, if we were to look back from the year 2000, what would the 1990's be characterized by?

POSSIBLE NEW DEVELOPMENTS IN THE SECURITIES INDUSTRY

Senator HEINZ. In terms of developments in the industry?

Mr. BREEDEN. I would hope that they would be characterized by an increase in the savings rate, in part for demographic reasons, as the baby boom generation ages somewhat.

Hopefully the rate of savings, as those individuals move into a——

Senator HEINZ. Are you predicting an increase in the savings rate?

Mr. BREEDEN. You're asking me to look into my crystal ball, so, without warranting or guaranteeing, I'm just trying to respond.

Senator HEINZ. I'm not asking you to say what you'd like. I'm asking you for what you think the world is going to be like.

Mr. BREEDEN. I would expect that we will see a somewhat higher rate of savings in the 1990's than we did in the 1980's, and I certainly hope I'm right about that, because we need to have a higher rate of savings.

Senator HEINZ. Why do you think we might have a higher rate of savings?

Mr. BREEDEN. Well, because of the demographic factors.

The baby boom generation will be at a stage in life, and an age and a position, careerwise, where their attention will turn more toward retirement savings, than perhaps has been true previously. People in their 40's may do a little more savings than people in their 30's.

And in part, my generation is, I expect, going to spend a little more time—having acquired homes and formed a household and gone through the heavy consumption expenses at that stage in life—turning some attention to savings.

So I would expect the demographic factors, in part, will result in some higher savings.

Senator HEINZ. What will the impact of that be on the industry?

Mr. BREEDEN. Well, it will certainly have an impact on all the financial services industries, as we have less of a penalty, I would

hope, in terms of cost of capital. And that, in part, depends on what kind of job we do in controlling Federal spending.

But, if we have a little more supply of capital than we've had in the United States over the last decade, and perhaps a little less demand by the Governmental sector than the private sector——

Senator HEINZ. Well, we're off to a bad start.

Mr. BREEDEN. Yes.

Senator HEINZ. As you know, what we promised in the way of deficit reduction for fiscal 1991 has turned into a major deficit increase according to the reports that were published this morning in every newspaper in the country.

You may be right about individuals saving more, but there's not much encouragement on Government dis-saving less. Dis-saving is what the Government does when it runs a deficit, and of course, savings go the wrong way when the deficit increases.

Let me ask you about this.

One of the things that clearly did characterize the 1980's is that securities firms, by your testimony, have been engaged in what you might call more risk-based activities. This was due to sharp reductions in commission income, and more recently a downturn in mergers and acquisitions reduced related fee income.

Do you see that trend continuing?

If so, what are the implications for your oversight of that activity.

If you don't see this trend continuing, why not?

FIRMS ENGAGING IN RISKIER ACTIVITIES

Mr. BREEDEN. We have unquestionably seen an increase in the proportion of revenue that firms are deriving from riskier activities. Some of it has come from the index arbitrage trading areas, where some firms have found conducting these activities to be highly profitable, notwithstanding what many would regard as the nonconstructive impact of those activities on the broader marketplace.

Others have sought earnings in takeover transactions through bridge lending activities. Those are riskier activities, as I indicated, because the firm is putting its own capital on the line.

Senator HEINZ. Do you anticipate more of those risk-based activities, more risky activities, that is to say, where the capital of the firm is placed at risk, whether it's a bridge loan or some other form of a merchant banking and equity investment kind of activity. Do you see that kind of approach increasing or decreasing in the 1990's?

Mr. BREEDEN. It's very hard to answer, Senator.

Senator HEINZ. Let's assume it's increasing.

If you knew for a certainty that the securities industry was going to engage in even more risk-based activities, what would be the implications of that for SEC oversight of the industry?

Mr. BREEDEN. Probably twofold principally.

As I mentioned at the outset, we need to get a handle on the entire holding company's risk profile, and not just a piece of the company. The holding company risk assessment provisions that the Congress passed last year, are very important, so that we can avoid

what has happened in the past. Previously these principal risk-taking activities, such as bridge lending, were going on in a corporate affiliate, across the corporate border from where the oversight was. Firms were able to conceal the degree to which they were staking the health of the overall firm on particular transactions. Now Congress has given us the ability to cure that problem, and we intend to cure it.

The second step, in addition to having the ability to look at the entire firm and discover where the risk is, is to make sure that our capital rule is not attuned to an era in which losses, if they might occur, happen slowly and gradually. We need to make sure that we have a capital rule that measures and requires adequate provision for the risk of sudden loss, as is more possible with these types of proprietary activities.

Senator HEINZ. In your statement you, in effect, complimented the industry on having a very healthy capital base, $36 billion as I recollect you indicated, even after deductions and haircuts, it was $13 billion in excess of——

Mr. BREEDEN. Of requirements.

Senator HEINZ [continuing]. Of requirements.

Should we take that to mean that you have no concerns about capital levels in the future?

That you believe that the industry, for example, is not in a period of long-term decline and that the 1990's is a temporary setback for them?

No doubt it's a heavy setback, at least 48,000 people have been laid off. Some analysts say another 40,000 or 50,000 people are going to lose their jobs on Wall Street and around the country.

Is there any concern, on your part, that we might be looking at a longer term erosion, rather than just a short term downturn in the securities industry?

Mr. BREEDEN. Oh, absolutely.

I don't know whether it's short or long term, and we'd better be prepared for both.

As I indicated earlier to the chairman, there are some elements of cyclicality affecting part of the operating results, but I think part of it is also long term.

Senator HEINZ. What are the main elements of that longer term impact?

Mr. BREEDEN. Well, certainly the declining participation by individual investors is one on the brokerage side.

There has been a long term trend that's been underway every year since 1984. We have had more redemptions of equity securities by LBO's and buyouts and takeovers than we've had in all the offerings of equity securities, either initial public offerings or offerings by seasoned companies.

So we have been steadily chewing up our equity base and replacing it with debt.

Senator HEINZ. Is that likely to continue?

Mr. BREEDEN. I would hope that we are going to see a turnaround in 1990 and, if the 1980's were the decade of leverage and debt, that we might return to the virtues of equity-based financing for our companies and our economy in the 1990's.

But that trend in which we have seen a substantial decline in the number of initial public offerings, the number of companies going to the market for securities of a longer term nature and of an equity nature, has had an impact on the revenue base of the firms.

And to some degree, the M&A fees, in the last half of the 1980's, probably helped mask some of those underlying conditions. I think firms probably were slow to adjust to the changes not only in the brokerage business, but also in the underwriting business, because they had such a gusher of fees coming out of M&A activities that they could overlook it.

Senator HEINZ. If the chairman will allow me two more questions in this vein.

Senator Kassebaum, I know, has some good questions.

How would the securities industry be affected if the following occurred: first if it were correct that we would see a slowdown, both in M&A and in converting equity to debt. There are some signs that there may be a permanent slowdown in that area. The junk bond market is nonexistent, and that was a major driver of the M&A activity; it permitted it, it facilitated it.

Second, if the increase in individual savings that you indicated, in fact, was outstripped by the creation of Government debt which is, at the present time, anybody's guess, but, based on this year's news, much more likely than unlikely, so that you had neither additional savings available to go into debt or equity, and a decline in the kinds of activities associated with M&A and junk bonds and other kinds of creative and innovative financing. Third, if Congress followed your recommendations, for example, on dealing with program trading and financial futures trading. And finally, if there was, as the administration intends to propose, a major financial restructuring package enacted by the Congress. Certainly the administration will propose that the financial services industry become more homogenized. They are highly likely to propose that nonsecurities firms be allowed to get into the securities business on some basis, so there will be additional competition for securities firms.

Mr. BREEDEN. I think we could safely rule out the prospect it would be boom times.

Senator HEINZ. Would the securities industry be limping along, or crippled?

Mr. BREEDEN. Well, there certainly would be pressures, and, if all the factors that you hypothesized were to occur, depending on their relative degree, you certainly would see an exacerbation of some of the trends that have been occurring. You would see a worsening of the pressures on the industry to contract, in terms of numbers of firms and numbers of employees, as the number of transactions decline, as transactions take place in a less value-added environment, such as underwriting of debt securities, where the fees are generally lower than the underwriting of equity securities.

As you see an undercutting of the traditional business activities of the industry, obviously that would put pressure on the number of firms and the size of the industry.

RISKS TO THE SMALL INVESTOR

Senator HEINZ. The only followup to that, and then I will yield, is, are there risks to the small investor from those kinds of trends, beyond what the small investor has already been exposed to or do you think you can protect the small investor with the tools you now have?

Mr. BREEDEN. I think we can protect the investor, and it's a critical distinction, excluding the investor in a brokerage firm which, depending on the firm, if your string of hypotheticals——

Senator HEINZ. I'm not talking about the investor in the brokerage firm.

There may be some present in the audience, but those are not the investors that I had in mind.

Mr. BREEDEN. Well, and I hope that they do well, also.

But I think that one does have to distinguish between the health of the industry, the level of profits that the securities firms are making, and the level of protection of the public, who are customers of those firms.

As I tried to indicate in my statement, and I was not complimenting the industry on its capital levels as much as I was stating the facts about what the capital levels are, capital levels at the moment are high, and we have been able to handle the decline in the number of firms that has occurred, so far, without any loss falling on the customers of those firms.

The small investors have been protected, where we had a failed firm.

Even in the Drexel case, the largest failure in history, by far, and the Thomson McKinnon case, which was another major case, we were able to transfer accounts, so that the public customers were not impacted.

That's our goal—not to prop up a given number of securities firms; it's up to the industry to find a way to be profitable in the market conditions of the 1990's; that's not our job.

Our job is to make sure that those who are not successful at that don't leave a consequence for their customers.

And that, we are determined to do, and I believe we have the tools to do.

Senator DODD. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

Chairman Breeden, I happen to believe that I think it's been almost criminal, what we have done through the 1980's, to allow the debt equity ratio to become what it has.

The fact that equity has shrunk by $500 billion, while debt has increased by $1 trillion, has closed off options to us now in the period of difficulty that we face, that we should never have, I think, encouraged by some of the tax laws, for one thing, that we've done.

You talked about chewing up the equity base.

Have you given any thought to perhaps in the future should we consider making dividends deductible in order to increase firms issuing equity instead of looking to debt?

Mr. BREEDEN. The current tax code, relatively speaking, rewards the issuance of debt and is severely punitive to the issuance and holding of equity.

I think that that impact has played a part, although it's not the sole reason, in the trends we have seen.

And, from my perspective, that induces greater fragility in the financial structure of the country than is desirable.

I would like to see the holding of equity securities at least treated on a par with the incentives we create for debt.

Senator KASSEBAUM. So you would support considering allowing deductions for dividends, and to pay for that, restricting the deductibility for debt?

Mr. BREEDEN. Well, I'm going to take refuge in the fact that tax policy is obviously not the purview of the Commission, and it would not be appropriate for me to suggest a view on a specific tax proposal.

But I would say that it would be my personal view that it is not good logic, nor is it good economics, to reward the holding of debt to the exclusion of the holding of equity.

It drives up the cost of equity capital. That results in there being less equity capital available. And that leaves our companies in a more fragile long term structure, in facing international competition, than when they're not leveraged to their eyeballs.

I wish that the tax code had less incentives for leverage than exist today.

Senator KASSEBAUM. My apologies for missing your statement. I believe you did touch on the fact that the industry, given the pressure it's under, is having to look to reductions, just as everybody else is.

And given your strong support for basically the financial services reform, and part of that, allowing banks to enter into the securities field, is this the best time to press forward with actually an expansion, rather at the same time as we're talking about reduction?

I think this was touched on by Senator Heinz, and perhaps Senator Dodd, as well, but I don't know that you gave a, you seem to be sort of saying both ways, like we all do.

Mr. BREEDEN. Well, I hope I've always been perfectly consistent, Senator, on that.

MODERNIZATION OF THE U.S. FINANCIAL INDUSTRY

Mr. BREEDEN. I have, in the past, and continue to support, an overhaul and modernization of the U.S. financial structure.

We are operating under laws in many cases drafted in the 1920's and 1930's, at a time when most of the elements of the current financial system didn't exist.

I can't, for example, explain why, in an age of global markets, it is good public policy to have Federal laws that prohibit the creation of a national securities market, and of a national banking market.

It seems to me, we should be maximizing our liquidity by creating the unified markets in the same way that the European Community is doing, rather than minimizing our liquidity by allowing 50 different States to fragment our marketplace.

And there are a large number of other areas in which I think an overhaul of the current system could help us produce lower cost capital for the users of capital. And, at the same time, a more successful and stronger system of financial institutions.

That should not be translated by anyone into an endorsement that we will solve all our problems if we simply let the banks into the securities business. Because, as my testimony indicated, those who think that there's this fountain of profits in the securities industry that will cure the income problems of the banks have not looked at recent numbers. There are no profits, at present, in the securities industry. And so, allowing hundreds of thousands of banks to enter the securities industry is certainly not going to produce the income that they may need.

I think we have to be very careful to make sure that we try and overhaul the system, but that we do so in a sensible way.

Senator KASSEBAUM. Well, I certainly would agree with that. I would think it would be hard to disagree with that. I suppose we have to deal with it and would deal with financial services reform in a little different light, considering the conditions under which we're operating right now.

And it seems to me that it's going to make it difficult, perhaps, to be able to do some of the things that we might feel are necessary simply again because we've got just this debt overhang that I think is going to tie our hands to a certain extent to do what we might feel is best for the long run.

I just would like to touch, Mr. Chairman, on one other question that I think has been addressed as well, and the talk of the individual investor and the institutional investors, and the dramatic growth of course that shift.

Do you think it's important to get back the individual investors? Individual investors have tended to be the longer term investor. Is that gone with the technology that has sort of met a rapid participation in the market by anybody, technologies changing us in ways beyond an institutional investor's ability to compete?

Mr. BREEDEN. Well, one of the reasons that I tried to focus on the returns that have been available to investors for long term savings, for families that want to plan for their retirement, for the educational needs of their children, for any long term purposes, is that the securities markets going back not just a few years, but going back decades and decades, have provided, by far, the greatest return for long term savings.

And not only have they therefore performed a great service for those investors in helping them reach their financial goals, much more rapidly than if they had chosen other investments, such as Government securities or bank certificates of deposit, not only have the investors reaped a reward, but so has the economy. Because the funds going into that capital market are available for use by companies who want to build new plants and equipment, and do research and development, and build a stronger economic base.

And I'm very concerned, not only about the trend of individual investors to steadily reduce their holdings of equity. In the late 1960's, the average American investor across the country held, of all of their financial assets, almost 50 percent in the form of equity securities. Today, that is less than 20 percent.

insurance. Among other things, the Investment Company Act requires the safekeeping of fund assets, limits leveraging, and prohibits self-dealing. The Act also requires that 40% of a fund's board be composed of independent directors and mandates purchase of a specified level of fidelity insurance for protection against larceny and embezzlement. In addition, most mutual funds must mark their portfolios to market and stand ready to redeem their shares at their market value each business day.

The Investment Company Act provides for routine and special inspections of investment companies. Routine, on-site examinations of all investment companies are an important part of the Commission's role in protecting the savings of investors managed by these companies. At my direction, during 1991 the staff will examine the operations of most money market funds and most funds that are part of the industry's hundred largest fund families. These mutual fund families account for about 90% of all mutual fund assets.

In 1989, the mutual fund industry grew by almost $172 billion, the second largest annual increase on record, exceeded only in 1986. Through November 1990, the industry grew by another $96.3 billion. The Investment Company Institute ("ICI") has predicted that mutual fund assets will grow at a rate of 12.1% per year in the 1990s, down from the 26.8% annual growth experienced for the period 1975 through 1989. The ICI predicts that mutual fund assets will reach $3.5 trillion by the year 2000, and will account for 18% of household discretionary financial assets by the end of the 1990s, up from 14% today.

Money market funds now account for about 48% of total mutual fund assets. In 1984, there were 329 money market funds with assets of $209 billion in 13.5 million shareholder accounts. Today there are approximately 725 money market funds with more than $494 billion in assets in 21.4 million shareholder accounts.

Many investors have come to view money market funds as alternatives to bank checking and savings accounts, despite the lack of government insurance. Good investment returns, the ease with which investments can be made and tax consequences recorded, features such as check writing, and a solid track record of paying back one dollar for each dollar invested have

contributed to investor confidence in money market funds over the past 15 years.

This solid track record is not accidental. The Commission continues to monitor money market funds carefully. Recently, following several defaults in the commercial paper market, the Commission proposed amendments to rules relating to these money market fund investments to reduce further the risks to which a money market fund could be subject. I expect the Commission to approve final amendments to the money market fund rules in the very near future.

Not all mutual funds, of course, have the stable asset values of money market funds. Assets of high yield bond funds declined from their peak, $35.8 billion in June 1989, to only $19.9 billion in November 1990. About 74% of this decline was due to decreases in the market value of the high yield securities in the funds' portfolios, with the rest caused by shareholder redemptions. The Commission is also closely monitoring this sector of the mutual fund industry.

25

Conclusion

In conclusion, the Commission is concerned about the reduced profitability of securities firms in 1990. Our concern is tempered, however, by our confidence that the industry will, as it always has, bring expenses and revenues into line, and return to profitability. Moreover, we believe that the securities industry, despite its current profit problems, is serving well its basic functions of providing capital to companies and opportunities for investment to individuals. Finally, and most important, the Commission is confident that securities firms have adequate capital, and that the SIPC fund has adequate reserves, to handle this period of adversity without any losses to brokerage customers due to brokerage failures, and without any call on the federal government line of credit to the SIPC fund.

So we've gone from 50 percent holdings of equity to under 20 percent. In this decade of debt, it was more attractive to hold debt, in part because very high yields on debt securities, not only high yield corporates, but also relatively high yields on Government securities.

Consequently we've had a massive shift of the portfolios of the American family away from equity securities, and into debt securities.

Senator DODD. But, there are factors in addition to the yield: market breaks in 1987 and 1989, the lack of confidence, the dominance of institutional investors. It wasn't just the attractiveness of the debt securities, but rather the fear of getting taken to the cleaners in the equity market.

Mr. BREEDEN. Well, Mr. Chairman, I think that is also a factor.

There are a number of factors. I don't think in any shift of that magnitude, going on for a 25-year period, there is any one single explanation.

Certainly, there is concern about the volatility and the degree to which we have exalted forms of financial activities that contribute not one whit to economic growth, to jobs, to productivity of this country, but simply facilitate daily transaction volume in some of our markets under other regulatory systems.

There are a number of factors that have produced this trend.

It's not just the declining participation of the individual investor in the sense of the brokerage business; the net result is worse than that. It's broader than that. It's also a declining attractiveness of equity securities holdings, at all.

I think that this has negative implications for the strength of the U.S. economy.

We need to focus on making holdings of equity securities more attractive. And also, to help people recognize the existing attractions.

I wasn't trying to sugarcoat the existing situation in trying to point out some of the strengths of the system, but rather trying to suggest that the individual investor should focus on the fact that there are good returns available in the securities markets, and they can invest with safety and with confidence. We have a good system. It works. We are able to protect the investors, even though firms may encounter trouble.

However, I do encourage this committee, and look forward to working with you, on ways to try and make the equity financing base of the country stronger over time.

Senator KASSEBAUM. Thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Kassebaum.

And I apologize for interrupting on that one point. But I want to underscore Senator Kassebaum's concern about the direction we're heading.

I don't think you're going to have increased savings just because we want it to happen.

And I think that the baby boomers, while certainly the tremendous consumption may be dropping off as people get older, what is also true is their income growth shrinks dramatically.

The major income earning periods occur exactly when consumptions costs increase. As those decline, historically, people as they

enter the latter years, the 1940's, the 1950's, also see their income growth shrink dramatically.

And without some inducements for them to take those additional savings, I think will be difficult to get an increase in savings.

My hope is we'll have some public policy that will make that more attractive than it has been.

CAPITAL GAINS TAX

Mr. BREEDEN. Mr. Chairman, not to venture into an area that is more controversial politically, as the head of an independent agency, but I would just note, in passing, that one of the reasons the President feels so strongly about the desirability of cutting the capital gains tax rate, is not out of any sense of trying to benefit the wealthy but to try to address this problem of the attractiveness of holding equity securities.

To the degree that people take all the risks that exist in the equities securities market, and end up with a gain, the current tax situation, both the double taxation of dividends and the lack of capital gains treatment, in effect, relatively speaking, penalize those that have taken those risks and make taking those risks less attractive.

I think there has been a very strong concern on the part of the President to address this underlying trend, away from savings and investment and the long term attractiveness of equities.

Capital gains is certainly not something that would merely benefit a few, very wealthy individuals. There are more than 50 million participants in the securities markets, every one of which that would potentially benefit from that kind of change.

Senator DODD. Would you also express the same kind of support for a return to a strengthened individual retirement accounts?

Mr. BREEDEN. Again, I have to disclaim——

Senator DODD. You're pretty good on capital gains.

Mr. BREEDEN [continuing]. Particular emboldened proposals.

Senator DODD. You can't be selectively courageous here, this morning, you know.

Mr. BREEDEN. That's not unknown. [Laughter.]

Mr. BREEDEN. I would just say, personally, I favor incentives to savings and long-term investment. And, if one form of doing that is not acceptable in the process, we need to find some other forms.

Because the bottom line is that the trends are moving in the wrong direction. We've piled up debt, and we've undercut our production of equity in this country and the attractiveness of holding it. We need to reverse those trends.

Senator DODD. That's for certain.

And joking aside, Richard, one of the reasons I've found you to be such a successful Chairman of the SEC is because you're not afraid to speak up. I think it is an enlightening and refreshing approach you've taken over the last couple of years.

And not to spend any more time on this particular subject matter, I would hope that you would speak up. I think it's very important that we have people come forward.

We've got a real crisis on our hands, and it's going to take people who have some vision and understand these things, and a willingness to step forward.

And I realize there are risks involved in that, but nonetheless, it's vitally important.

And so I appreciate your comments on those particular points.

Let me turn to public finance. We're going to run out of time here this morning.

But I'm deeply worried, as I know my colleagues here on this committee are, about what's happening in our cities and counties and local governments across this country.

You don't need to be a PhD in political science to know what's happening in terms of cutbacks and tax increases that are occurring at the local level. There's a tremendous strain on local governments to meet the local service needs, but a shrinking ability to be able to afford it.

We know the important a role municipal bonds have played in meeting the needs of local governments.

And yet, simultaneously, we also know that there have been some serious questions raised about the safety of outstanding municipal bonds, and the prospects for cities raising new funds at reasonable rates.

I can't emphasize, enough, how important a role that market has played at the local level.

And now we see a combination of spending pressures on local government for a wide range of services, new taxes, forced cutbacks as a result of growing budget gaps, are uncertainty that's occurring as a result of questions being raised about credit quality of these bonds, I wonder if you might share with us how you view the overall safety of the municipal securities market at this time.

Second, what steps is the SEC taking, and what steps should we be taking in Congress, to ensure the integrity of this important market.

And what are the prospects for our cities and local governments facing serious financial shortfalls, to use the municipal markets to meet their financial needs?

MUNICIPAL SECURITIES

Mr. BREEDEN. Well, Mr. Chairman, those are a series of certainly excellent questions.

At the outset, let me note that, as you know, our role in the municipal securities is much more limited than our role in the traditional equity securities market.

We not only do not have jurisdiction over the offering of municipal securities, we have been prohibited from attempting to exercise jurisdiction over municipal securities in a number of areas.

Offerings of municipal, State, and local government securities, while subject to certain of the antifraud provisions and some portions of the securities laws, are not subject to the full panoply of the securities laws, and our oversight, in the same way as corporate securities would be.

I would not characterize it as correct to say that the entire market is either good or bad.

I think the problems that have occurred have largely been the problems of defaults by particular issuers.

Like investment in the securities of corporate issuers, it does make a difference who the issuer of the bond is, what their balance sheet looks like, what their finances look like, and how responsible their budgetary practices are.

Investors in State and local government securities, like investors in corporate securities, need to look carefully at the security that they are being offered, what its source of repayment is, and they need to be cautious, before they invest.

There is, in some issues in this market, considerably less secondary market liquidity than there might be in corporate securities. Consequently, an investment in these securities may typically need to be held for a longer term than a holding of a widely traded stock, like AT&T or IBM.

This also reemphasizes the importance of disclosure, and the necessity of investors looking very carefully at the security that's being offered.

We've been trying to enhance the availability of disclosure materials. However, we cannot specify the content of disclosure documents for a city or county or State government, the same way we can for corporate issuers. But we do have some authority to make sure that the disclosures that are offered are circulated and made available, and we've been trying to facilitate the growth of information libraries, where investors will have better access to disclosure materials.

I think that there have certainly been problems in the market. It is important that investors have confidence in the market and that they have confidence in the disclosure that they receive, so that there is a willingness to participate, because it certainly is an important source of financing for governments across this country.

Senator DODD. Let me turn to another subject.

Senator Heinz and I in November wrote you a letter, asking your views on the Joint Treasury Federal Reserve SEC study on the Government Securities Act.

We asked whether the SEC would recommend legislation going beyond the recommendations of that study.

You'll recall that the GAO, in a report last fall, recommended that there be sales practice rules for Government securities dealers, and made recommendations for added protection in the market.

Has the SEC developed its recommendations?

Will you ask for legislation going beyond the joint studies recommendations?

For example, do you believe there should be sales practices rules for Government securities dealers?

Mr. BREEDEN. We have been looking at that question and have been in the process of formulating our views on what changes, if any, should be made legislatively.

I personally believe quite strongly that we should go beyond the joint report in the area of information concerning trading data. One level of information is available for primary dealers, and for everybody else there's dramatically less information available as to

current, up to the minute reporting in trades and volumes and prices.

I strongly believe we need greater transparency in that market than we have today, and would support personally steps in that direction.

SALES PRACTICE REGULATION

The issue of sales practice regulation is an important one. There are certain antifraud standards in place. I am not aware of extensive empirical data on how much abuse there is. And we're trying to look carefully at that and haven't reached a conclusion yet on the need for legislation in the sales practice area.

Senator DODD. When will you be prepared to respond to that?

Mr. BREEDEN. Well, we'll certainly be looking at that actively and would expect to try to reach a position on that in the near future.

Senator DODD. Can we say sometime later this winter we'd be able to get an answer on that?

Mr. BREEDEN. Yes.

Senator DODD. OK. It will help us dramatically if we could get your proposal early, because there obviously will be others with a differing point of view.

I understand you're under a lot of pressure with a number of other issues.

Mr. BREEDEN. Just a few.

Senator DODD. Yes.

Mr. BREEDEN. Just as one overall, quick comment, I do, in general, strongly support the idea of what is oftentimes referred to as functional regulation. And I believe that offerings of securities, any securities, ought to be handled under the same basic approach. You need good disclosure. You need adequate information. You need regulation and oversight of sales practices.

And whether it's a security offered by a bank or offered by a corporate issuer or offered by a government, it ought not theoretically to matter, what is important is to set up the kinds of protections we need for the investing public and then see to it that, whatever the issuer, we try and achieve that level of regulation.

Senator DODD. Let me move to another area.

I had the privilege of addressing the American Bar Association's Securities Division a few months ago, after the passage of the Enforcement legislation. A number of different people there raised the concern about whether or not we had gone too far with that legislation.

I know you and the others at the Commission have heard this over and over again. I've made the commitment, in fact, and indicated that I certainly believe that we ought to take a good look at the legislation and see how it's working to determine whether or not what we've done there makes sense and how effective it is.

One of the implications that's being suggested by some of the securities attorneys is that we actually may have hurt the Enforcement Division by, in fact, promoting greater litigation than was otherwise the case, and creating a backlog of litigation.

They say you've asked for far tougher settlements of cases. I know I'm not telling you these things for the first time. Defendants, instead of settling, are litigating.

And so, instead of streamlining and moving the process along, you're ending up with more of a backlog.

How do you respond to those kinds of criticisms and concerns? Is it too early to make any judgments like that in your view?

Mr. BREEDEN. Mr. Chairman, I strongly supported the Enforcement legislation, believed it was the right thing to do.

Mr. BREEDEN. I strongly believe that the enforcement remedies' enhancements that this committee helped to enact was the right thing to do. And, sure, defendants who are being subjected to more than a slap on the wrist are going to fight harder to prevent a meaningful sanction from being applied to them.

But I don't think that, when people have demonstrated the capability to try and steal tens or hundreds of millions of dollars from public customers, that a maximum sanction of a nasty letter from the SEC is sufficient.

And if that means we're going to have to litigate some more cases, then I hope that the Budget Committees will give us a few more litigators and we'll be perfectly happy to go out and fight. We have a pretty good track record. We think we get a darned good return on the taxpayer's investment.

We've recovered over $1.4 billion in the last 5 years for investors who were cheated and recoveries to the Treasury. That exceeds rather considerably the resources we expended to achieve those results. And I don't think we have to be bashful for the fact that some people who choose to go out and prey upon the investing public don't like the fact that the SEC is going to put a little more heat on them.

At least as long as I'm Chairman, we intend to do that.

Senator DODD. Well, I'm glad to hear you say that.

I do think it's important that we take a look and have some oversight on the legislation, to see how effective it's being implemented.

But, I couldn't agree with you more on your last comment. And that's the job. In fact, I was delighted at the SIA Convention to have such a positive response from the industry with regard to the needs of the SEC.

This is not always a typical response from an industry.

With respect to the pay cap issue, it's a very difficult political question here. But if you're going to do your job effectively and have an agency that does its work effectively and does not lose talented people, we're going to have to be competitive with other Federal agencies.

In the absence of doing that, I think you're going to run into serious problems—more for that reason than because of the passage of legislation.

So I appreciate the industry's earlier response to that particular call, both from you and this committee and others. And we've got that battle to wage in front of us.

Last, before turning to my colleagues and welcoming Chairman Sasser of the Budget Committee as well to the committee here this morning, you and I have chatted both informally and formally

about the upcoming financial reform legislation that will be coming forward.

You've already indicated here this morning about where you come out on this issue in terms of the securities industry. In fact, the securities industry itself, under the leadership of Bob Downy and now under Mr. Horowitz, are talking about some very different positions than have been the case in the past regarding product deregulation.

And, yet, the concerns will come up. Are we getting—are we moving in the direction that created the very kind of situations we saw ourselves get into with the thrift industry, where we allowed for product deregulation and, all of a sudden, we found ourselves in a mess.

And the concern here and being expressed by many is that, while there's a desperate need for capital, if we allow too much product deregulation here, we're just inviting the same kind of chaos that we've witnessed in the thrift industry and may be seeing in the banking industry across this country.

I would ask you to comment on that, generally, if you would.

Mr. BREEDEN. Well, there are risks of those types of developments. And I think Congress, in approaching any reform of the system, has to ask some tough questions about that.

There are ways, I believe, of safely overhauling the current system and reducing some of the barriers to affiliations between different types of firms without undercutting safety.

But, if we were to simply say, well, we're going to launch every under-capitalized bank into the securities business and let them do it within the scope of the Federal safety net and expect the taxpayers to stand up and pay for their mistakes, I wouldn't favor that type of reform.

I think it does very much depend on the type of structure. We need to make sure that what we do is reduce unnecessary impediments to people conducting a soundly operated financial business, but not get carried away with any pie in the sky aspirations that we're going to give people carte blanche, backed by the taxpayers, to go into new lines of business without making sure that it's their investors who pay for any losses, not the public.

There are a number of possible reforms. Obviously, the Treasury's proposals on this subject will be complex and detailed. I don't know what their final form will be. There are a number of basic issues that are going to have to be confronted such as the safety issue you mentioned. Also, there are competitive fairness issues. There is a tradition in the banking world which I alluded to in my testimony of prohibiting the very types of companies that currently own securities firms—diversified industrial companies, such as American Express, General Electric, Sears, Ford Motor—from owning a bank.

Those types of companies have been expressly told by Federal law:

You need not apply to invest in a U.S. bank.

And if we're going to say that banks are free to make acquisitions in the securities business, I would not support legislation that did not make it equally free for those who are active in the securities business to make acquisitions of banks.

If we're going to remove the impediments, they have to be done on a two-way street, fully reciprocal and let competition dictate the winners, not say that banks can acquire securities firms but not the other way around.

There are a number of details that have to be looked at very, very carefully. Hopefully, one of the lessons from the early 1980's and late 1970's should be that.

Not every reform you make will prove to be a good one. We have to look very carefully before we made a change to make sure that what we're proposing is sensible.

Senator DODD. I should have made the point—we see the banks, commercial banks, in a weakened position. We watch the securities industry with its lowest profit levels in 15 years. And the idea of having two weakened industries getting together when investor-consumer risk could be heightened is, the point that underlies the question.

Mr. BREEDEN. And this type of reform is not going to be a panacea to avoid the need for contraction. If you've got over-capacity in both banking and securities, then allowing affiliations between the two does not mean that you've avoided the pressure for reducing capacity. That's still there. And we need to look at how to make a long-term transition to industries that are on a stronger footing, both in banking and securities.

Senator DODD. There is one additional matter I should raise with you. I mentioned the Bank of New England as we started out. In November of last year, the Commisson brought an action against the Bank of New England. And I applaud what you've done.

We've spent a lot of time up here talking about depositors, a lot of time, and rightfully so, about taxpayers and what they're being asked to pay in order to deal with these problems.

But a forgotten constituency in all of this is the shareholder. And, yesterday, with all the news about the Bank of New England and the Connecticut Bank and Trust in Connecticut, we constantly reassured the depositor things were all right.

One constituency to whom we could not offer any hope to at all was the shareholder. They've lost in that particular case.

I wonder if you might comment on how many of those cases you bring. I know that one specifically. Is that an area you intend to pursue more aggressively than has been the case in the past? Or has that been an isolated case?

PROTECTING INVESTORS IN FAILED BANKS AND THRIFTS

Mr. BREEDEN. No, Mr. Chairman. Shortly after I became Chairman, I formed a special unit in the Enforcement Division to review cases arising out of financial institutions.

This case was brought by that unit and there are a number of other cases in the pipeline.

Your point is exactly correct. The kind of forgotten casualty in the problems of the banking and thrift sectors have been some of the investors. In the last 5 years, we've seen about 1,100 institutions fail. And somewhere between 80,000–100,000 individual investors have lost in excess of $8 billion in the failures of those institutions.

We currently exempt banks and savings and loans, though not their holding companies, from registration under the securities acts. And we exempt them from a number of the protections of the securities laws.

Consequently we have a situation where we have certain exemptions built into the law that ought to be repealed because banks should have to comply with the same kinds of disclosures that other types of companies do when they want to sell stock to the public. We have to start asking about whether allowing banks to tell shareholders that their assets are worth a number much higher than they know them to be worth is going to be acceptable.

And so I hope that's the last action we'll have to bring. That was a case in which investors were outright defrauded by a knowing overstatement of the value of the institution when it was conducting a public offering.

I don't like to see cases like that but, as long as we find them, we're going to bring them.

Senator DODD. Thank you very much.

Senator Sasser has joined us.

Jim, we welcome you to the committee this morning. Any opening statements you have.

Senator SASSER. Well, thank you very much, Mr. Chairman. I do have an opening statement. I'd like to have it included in the record.

Senator DODD. Without objection, so ordered.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Thank you Mr. Chairman for calling today's hearing on the condition of the securities industry. As you well know, the securities industry plays a pivotal role in capital formation, and economic growth, in this country. America rightly prides itself on having the best developed capital markets in the world. So the present weakened condition of the securities industry is not a good sign that we are going to have an easy climb out of the present recession.

Why is the securities industry weak? I think its condition reflects the broader problems in the general economy. In particular, in the 1980's America went on a binge of leveraging. Debt on corporate balance sheets increased by a trillion dollars, while outstanding equity of U.S. corporations shrunk by $500 billion.

Wall Street was consumed in a hostile takeover, junk bond and leveraged buyout craze that left many corporations in worse condition after, than before, these massive transactions. Many of the firms and the banks that financed these mega deals are now carrying portfolios of nonperforming H-L-T loans, and these loans threaten the solvency of these institutions.

Moreover, a healthy securities industry is dependent to a good degree on a healthy banking sector. Banks play a critical role in, among other things, clearance and settlement of securities transactions. But today our banks, and the Federal Bank Insurance Fund, are not in good condition. The administration and Congress must act quickly to ensure that the Bank Insurance Fund is recapitalized with the banks' own funds.

I think that ensuring the safety and soundness of the banking system will go a long way to injecting new vitality into the securities industry and the economy in general. Thank you.

I want to thank you, Mr. Chairman, for calling these hearings here this morning. I think they're very useful and will be very helpful. And I want to say to Chairman Breeden that I very much regret missing your opening statement.

However, I have read portions of it before arriving here this morning and find it's very interesting.

You've testified, Mr. Breeden, and I quote, that:

"The situation with the securities industry earnings are 'very bad'."

Now, we all know about the situation in the banking industry; there's a serious drain on profits in banking.

And then we're also told that there are problems in the insurance industry as well.

So, it occurrs to me that there's a serious profitability problem in the entire financial sector.

Mr. Breeden, is anybody making money in the financial services industry these days other than the gentleman that's doing the arbitrage work at Solomon Bros.? [Laughter.]

I noted that he had a $23 million salary, as reported in the Wall Street Journal.

Senator HEINZ. And don't forget the lawyers in your exceptions.

Senator SASSER. Well, yes, that is the case.

The questions I want to propound to you are:

Is anybody making any money in the traditional investment field or commercial banking? Are we seeing a trend? And what is the problem?

Mr. BREEDEN. There are earnings problems in each of the sectors but, in securities, as in banking and insurance, those are averages of the industry. And within those averages, there are some firms that are making money and others that are losing enough more to bring the average down.

I think about one-third of the large banks in the United States have a return on assets of around 1 percent, which is actually quite healthy.

So, even in banking, with the quite extensive publicity about the problems of some institutions, there are, in fact, a number of banks that have taken the steps to control their costs and are making money.

That is certainly also true in the securities markets. While, on an aggregate basis, this year will result in either a loss or a very, very small profit, there are some firms that have done much better than others.

So I think it does depend on the ability of each firm to control its costs, find a market where its business can be good, and to build a profitable company.

Senator SASSER. Well, I suppose one of my concerns is that, for the average citizen out there reading the newspaper or watching television or reading the financial news on a daily basis, there is no good news, it would appear. And there hasn't been any good news for a long time.

In conjunction with this, as Chairman Dodd indicated a moment ago, we have various sectors of the financial services industry telling us, well, our problem is that, in our particular area, we are too tightly circumscribed. And, if we could simply get over into another area of the financial services industry, then, of course, we could do much better.

Is the problem really overcapacity in the financial services industry? Is that what you were saying earlier, Mr. Breeden? Did I understand you to say that?

Mr. BREEDEN. Senator, I do believe that there is current overcapacity, at least given current levels of activity in the market in the securities industry. And there unquestionably is substantial overcapacity in the banking system.

Senator SASSER. How about in the securities industry?

Mr. BREEDEN. Yes. I think I would say that, at current levels of activity, there is overcapacity, which is why firms have been moving very sharply to reduce their operations, close branches, consolidate—exit some areas of business and reduce employment. Total employment in the securities industry is down almost 50,000 people in the last 3 years.

Firms have been moving to cut costs because at current levels of market activity there is overcapacity.

Senator SASSER. Is this a reflection of general economic conditions in your judgment? Or, are we seeing some sort of sea change in the national or international economy?

Mr. BREEDEN. I think there's some of both. Clearly, some of the operating results for 1990 in the securities industry reflect the uncertainties in the current world situation, the weakness in the economy, and a number of hopefully short-term trends.

Other aspects of the problems should not be overlooked as something that's short-term. There are some more fundamental trends at work. Technology has given us the capacity to handle volumes of money with fewer people and with fewer institutions. Yet, we have more so on the banking side than on the securities side, resisted the pressure for contraction.

Every time a bank fails, we tend to try to recapitalize that institution, find a buyer, keep it in the market.

Well, the market may be trying to tell us that we have more banks than we need given the state of our economy and the need for banking products. If we never allow a contraction to occur over a planned and drawn-out period of time, then that overcapacity will prevent healthy earnings until it's corrected.

Senator SASSER. Well, I'm concerned about fundamental problems. It's no secret that during the 1980's, we in this country relied heavily on foreign capital to fuel the economic expansion that took place during that decade, and we also relied heavily on foreign capital to help finance our Federal Government deficit.

But, over the last few months to a year, there seems to have been a shift. The United States, it appears to me and from what I'm reading, is no longer the investment site of choice. This appears to be particularly true with corporate equities.

According to the Federal Reserve, foreigners were net sellers of U.S. equity over the first three-quarters of 1990. And according to

the Fed, foreigners were the net sellers to the tune of about $50 billion.

Now, this contrasts with the previous 4 years when foreigners were very healthy net buyers of U.S. corporate securities.

It seems to me that the flight of foreign investors could increase the cost of capital to U.S. corporations here at a very tenuous time. If there are fewer buyers, then businesses are going to have to pay more for capital. The liquidity market could be diminished if there are fewer players, and volatility would be increased.

I'd like you to comment on this, Mr. Chairman, and also on how this reflects on the cost of capital.

And what, in your view, is the reason for foreign investors moving out of the United States to invest in equities?

Is this a temporary phenomenon in your judgment? Or, is this a reflection of a fundamental problem?

FOREIGN INVESTORS

Mr. BREEDEN. Senator, there are probably a number of factors at work. Certainly, if you look at the movement of markets in the United States and some of the countries where a lot of that investment came from, the U.S. market, relatively speaking, has done much better. We had a decline in the value of the U.S. market of under 5 percent last year compared with an almost 40 percent decline in Japan.

There may be some investors, for example, in Japan who've taken, relatively speaking, quite a beating in the home Japanese market and have chosen to reduce their holdings overseas and strengthen their financial position back home.

Similarly, our market declined only about a third of that of the London market. So, some weakness in foreign markets may be partly responsible. The fact that interest rates in Japan, for example, have been higher than they were traditionally has made investments in Japan perhaps relatively more attractive than they once were, and may have diverted some investment flow.

There may be concerns about the level of investment in the U.S. market given the projected position of the U.S. economy in any given year. There are a great many factors. I can't with any confidence try to identify all of them for you.

Certainly, anything that reduced the supply of capital without reducing the demand for it would help drive up the cost of capital and would not be a good thing.

I'm a little more worried about, and a little more interested in, trying to stimulate the growth of domestic equity than I am about trying to overcome the lack of domestic savings by importing capital from abroad.

But I think we obviously need to be concerned with the supply of capital whether it comes from domestic savings or overseas.

Senator SASSER. Well, I agree with you. We ought to be more concerned about increasing domestic savings and increasing the supply of domestic capital. But, I gather from your comments, Mr. Chairman, that you're not unduly alarmed about the fact that foreigners are selling their U.S. equities and moving offshore to make their

investments. And you don't view this as any fundamental problem but rather as a reflection of the international business cycle?

Would that be a fair assessment?

I don't want to put words in your mouth.

Mr. BREEDEN. I certainly care about the attractiveness of the U.S. market at all times, to all investors. But, I think, relatively speaking, if you look at the last year, the performance of the U.S. market has been very strong, has been with one exception the strongest performing market in the world.

So, while we have some problems, other markets have much greater problems. The particular factor you pointed out is not something that I would yet be extremely concerned about.

Senator SASSER. Thank you.

Thank you, Mr. Chairman.

Senator DODD. Thank you, Chairman Sasser.

Senator Heinz.

Senator HEINZ. Mr. Chairman, I just have one brief question. It has to do with, in a sense, the subject that you and Chairman Breeden were discussing a moment ago, which is the Bank of New England. My question is not so much about that particular situation, but the general case of where you get a major financial institution that gets into trouble and how you head it off.

I imagine that we get in the discussion of financial restructuring and deposit insurance reform and allowing banks to do securities activities, and vice-versa.

The question will be:

How do we intervene early enough to head off the kind of problem that we would all have liked to have had headed off to the Bank of New England, and of course many other depository institutions?

In that connection, I gather there is quite a disagreement between you and Jerry Corrigan, the president of the New York Fed, on the question of holding company regulation.

The reason this becomes, obviously, quite important is, as I understand it, you're in favor of functional regulation. I believe you've testified to the fact that, if you regulate each of the individual parts of the holding company, there's not going to be a problem and nobody has to have oversight of the holding company.

On the other hand, it's certainly been pointed out that, in early 1990, the bankruptcy of Drexel-Burnham, which you were very involved in helping to resolve, which was a financial services holding company, led to the demise of its subsidiaries, including a registered broker-dealer and a primary Government securities dealer.

Those went down because the holding company went down.

Some observers, therefore, have concluded that that experience reinforces the need for holding company regulation. More graphically, those observers state that the Drexel experience proves that you can't lop off the head of a holding company and expect the rest of the body to survive.

Others have done a postmortem on Drexel and have concluded the current system of regulatory specialists responsible for the health of the various parts of the holding company works, as I gather you do. They claim that the financial affliction of the hold-

ing company does not spread to its subsidiaries or the rest of the financial community.

My question to you, I guess, and I'm going to ask this of Dale Horowitz, if he ever gets a chance to testify, is:

How do the market participants view holding companies? Do they view them as a group of separate and distinct firms or as an integrated whole?

Is it not true that market participants were very reluctant, in fact, in some cases perhaps totally unwilling to deal with either Drexel's broker-dealer and/or Government securities subsidiaries, even though they were solvent?

INSOLVENCY OF HOLDING COMPANIES

Mr. BREEDEN. I have no quarrel with those who say that a large insolvency at the holding company level may cause the failure of underlying companies. That certainly was what happened in Drexel. I would expect it to happen in other types of situations.

But I think that proves nothing about how you ought to regulate holding companies because the possibility of insolvencies is not going to be eliminated by that regulation. The Bank of New England, which we've been discussing this morning, was also a holding company, a heavily regulated holding company under the authority of the Federal Reserve that had the authority to set consolidated capital rules and approve every application of every possible nature—and it failed at a loss, as has been reported, of more than $2 billion to the FDIC. Drexel didn't cost us a dime.

So I'm not sure which system works a little better from the perspective of protecting the taxpayer and protecting the deposit insurance fund.

We have a different——

Senator HEINZ. On that point, are you arguing that we shouldn't bother to regulate bank holding companies or this new creature, financial services holding company?

I heard your point. It's a serious point. What lesson does one draw from it?

Mr. BREEDEN. The lesson I draw is that regulation needs to be focused on the operating company where you have risks to public customers or to the FDIC fund or to the taxpayers.

If you have a bank, the business of being a bank and the capital that requires and the lending practices and all the safety and soundness, considerations, those ought to be regulated.

And the——

Senator HEINZ. But, suppose, instead of looking at the operating company, you have what you might call a real operator at the holding company?

How do you guard against that?

Mr. BREEDEN. Well, you guard against that by giving each regulator of the underlying operating companies such as the bank regulator, the ability to go up to the holding company level and examine what's going on and take action if the holding company is imprudently putting at risk the underlying operating company.

But, the broker-dealer regulator, if that company also owns a securities firm, should also be able to go do that. And so should the

insurance regulator, if the holding company owns an insurance company.

The holding company regulation that we've had in the banking system, the Bank Holding Company Act, is what I think could be fairly characterized as trickle-down regulation.

A capital rule is set up at the parent level, and we hope that the benefits of that trickle down to the underlying company, which is where the FDIC insurance is. I happen to believe you should focus the regulation on the bank and on the broker-dealer and let each of the regulators that has that line responsibility go upstream, and take a look at the parent holding company. This is exactly what I advocated before this committee in trying to obtain passage of the Market Reform Act.

It's not that holding companies shouldn't be under supervision. They should be. But, they should be under the supervision, examination and oversight of the bank regulator, or the securities regulator, or the insurance regulator, because each one of those agencies has a legitimate interest in seeing what the holding company is up to and what kind of risks that they're creating.

That knowledge is more important than trying to tell the holding company how to run its business.

General Electric, which owns Kidder-Peabody, is a holding company. We want to know what kinds of risks may be present in their overall company. The Market Reform Act will allow us to do that. But, it would I think be silly to suggest that the SEC or the Federal Reserve should set a consolidated capital ratio for General Electric and should dictate whether or not GE can build a new plant to build refrigerators.

That's a decision GE ought to make. We ought to be able to dictate how much capital it takes to run Kidder-Peabody, or how much capital it would take to run GE Bank and Trust.

Then, if they can't come up with it, we should be prepared to step in and step in quickly and close the institution—exactly as we did when the Drexel parent problem caused a problem at the Drexel subsidiary. When that happened, we didn't sit around. We stepped in and closed it. And we were able to do so without cost to the public.

That is, I think, a workable system. It's not going to prevent failures at the holding company level. Neither does bank holding company regulation. About 90 percent of the banks that have failed—80 or 90 percent—were owned by holding companies. And under the full panoply of bank holding company regulation, it hasn't stopped the failures at the parent level or at the subsidiary level.

So, the question is:

What kind of oversight do you want to have?

I think we all agree, and both Gerry and I certainly agree, that the holding company needs to be under oversight. But I think the approach of trying to set capital rules and approve acquisitions in unrelated areas does not really bear on the important job, which is making sure that the operating company has the capital it needs and is not engaging in improper practices.

Senator HEINZ. Thank you.

Senator DODD. Thank you, Senator Heinz.

Chairman Riegle has asked that a prepared statement of his be included in the record at the outset of these hearings and that will be done. He also has requested, Chairman Breeden, your comments regarding a piece of legislation that Chairman Riegle and I introduced at the end of the last Congress on the Federal Deposit Insurance Reform.

Apparently, you and he have had some conversations on that and so your comments to the record would be helpful.

I would lastly note that, before I turn to our second panel, the full committee will he holding a hearing tomorrow morning at 9:45 in this room on the Bank of New England situation, with our witnesses being FDIC Chairman Siedman and Comptroller of the Currency, Bob Clark.

Mr. Chairman, you've been extremely patient here this morning. We've kept you a couple of hours. And, frankly, we could have gone probably the rest of the day. There are many questions, but I think we've gotten a pretty good sense from you about where things are, some sense of what your agenda is.

And I want to thank you on behalf of both Senator Heinz and myself for your comments regarding the legislation last year. But, obviously, that would not have happened had we not had the full support of the SEC.

Again, it was a pleasure to work with you in the previous Congress and we look forward to a similar relationship with this coming Congress. There's a lot of hard work in front of us.

And I'll emphasize the point I made to you a moment ago. I think it's very important that we hear from the SEC Chairman on some of these broader questions that go beyond the limited jurisdiction of the Commission.

And you've done that a bit here this morning. I'm grateful for that and I know everyone else is on this committee. Whether we agree with you or not, I think it's vitally important we get that kind of an opinion.

Senator SASSER. Mr. Chairman.

Senator DODD. Yes.

Senator SASSER. If you have no objection, I would like to hear Chairman Breeden's very brief comments on the bank reform legislation and insurance reform legislation that you and Chairman Riegle have introduced, if he could do it briefly?

Senator DODD. Fine.

Mr. BREEDEN. Senator, it is extensive legislation. Consequently, it is difficult just to try to give you the very brief answer that you've sought, I think that there are a number of elements of that legislation that seek to move in what I would characterize as very constructive direction. Certainly, the legislation contains provisions designed to improve the reliability of accounting data in banking institutions and that is I believe very important.

This related to one of Senator Dodd's earlier questions.

How can we know when to take action?

Well, if we don't start with good information, either as regulators or as investors, we can't make sensible decisions. And the legislation has provisions designed to require movement toward market-to-market accounting, which I think is a positive direction in the

long-run for instilling confidence in the system by giving the financial data we release greater credibility.

The legislation also contained what I felt to be some very useful suggestions on how to tighten some of the discipline that is lost when you have an insurance program that pays off every conceivable loss.

Certainly, to the degree that we have an FDIC insurance fund that is declining in its level of reserves, we ought to at least question whether we can afford to pay people who have no claim whatsoever on that fund—uninsured depositors. Or how much those types of payments should be.

And perhaps over time—not a sudden change, not any change announced overnight, but through legislative action, which sets targets for the long-term in which we would try and identify more clearly what types of claims are within the safety net and what types of claims are outside the safety net—we can move in a constructive direction.

So I thought that there are a number of provisions in the legislation that are constructive, but it's a very detailed piece of legislation. An enormous amount of work went into it. And I can't do it justice giving you a quick answer on that.

Senator SASSER. Well, thank you very much.

Senator DODD. Well, that's helpful. But, if you would, maybe having some written responses on the other provisions of it as well would be helpful.

Again, we thank you for being here this morning.

Mr. BREEDEN. Thanks.

Senator DODD. Dale, we appreciate your patience in waiting here this morning. And let me, as I welcome you and Mr. Goldstein to the committee, let me, first of all, congratulate you on having assumed the chairmanship of the SIA. I should also point out that Saloman was a very profitable firm in 1990.

Is this how you got the job of the SIA?

Mr. HOROWITZ. No. [Laughter.]

It wasn't based on that.

Senator DODD. It wasn't based on profitability, huh? [Laughter.]

Well, you did a very good job and it's a pleasure to see you again. I enjoyed being with you at the SIA convention and having a chance to chat with you.

We're pleased to welcome you here along with Michael Goldstein.

Is Michael there? Yes, he is. Good to see you and thank you for coming as well.

We'll turn to you first, Dale, and your opening statements. Then, Mr. Goldstein. Then, we'll have some questions for you.

STATEMENT OF GEDALE HOROWITZ, CHAIRMAN, SECURITY INDUSTRY ASSOCIATION, WASHINGTON, DC

Mr. HOROWITZ. I have an opening statement plus . . .

Senator DODD. Both statements will be included in their entirety.

Mr. HOROWITZ. Thank you.

Senator DODD. And if you can paraphrase them, it may help move the process along.

Mr. HOROWITZ. Right. I will keep it reasonably short.

Mr. Chairman, good—I guess good afternoon. I am Gedale Horowitz. And I am senior executive director of Solomon Bros., Inc. in New York, a firm with which I have been associated for 35 years. I am here this morning in my capacity as chairman of the Securities Industry Association.

On behalf of the SIA, I would like to thank the subcommittee for the opportunity to participate in this hearing on the condition of the securities industry.

During the past several weeks, there has been general acknowledgement that the country is now in a recession.

This is not news to us in the securities industry, which has been in a recession now for over 3 years.

Roughly, one-third to one-half of all New York Stock

Exchange member firms have posted red in each quarter since the stock market crash in 1987.

Looking at 1990, for example, the industry barely broke even through the third quarter. Profit margins, that is, profits of the gross, as percentage of gross revenue, were less than one-tenth of 1 percent before taxes, while pre-tax return on equity was under 1 percent.

This was the lowest profitability our industry has experienced since 1974 and preliminary fourth quarter results predict a net loss for the year, which would make1990 the first full year loss for the securities industry since 1973.

In the 3 years since the October 1987 market crash, employment in the industry has dropped by at least 48,000 people, or 18 percent through this past September. There is little good news on the horizon for 1991 either.

Entry to our business is relatively easy, while competition is fierce. Only 10 years ago, there were slightly over 5,000 securities firms, mainly small, reporting to the SEC. By 1987, just prior to the October crash, this number had doubled to 10,000. Today, competitive pressures have been augmented to the point where the industry has overcapacity in many business lines.

In addition, the character of the business has changed. Diminution in commission revenues, traditionally a core component of industry income, to less than 17 percent of total revenues has led to increased reliance on underwriting, merchant banking and other transactions in which securities firms accept risk as principal.

At the same time, markets have become even more volatile. In addition to the industry's current problems of overcapacity, high-risk and low returns have only been exacerbated by technology and globalization. Nevertheless, the industry's capital remains quite strong and provides the economic foundation for long-term health.

It must be remembered that the U.S. securities industry has an unparalleled record in evolving capital-raising mechanisms to fund corporate growth and public improvements. There is a very direct connection between the health and performance of the securities industry and the well-being of the United States.

The American capital markets are the engines for our economy's growth and development and we, as an industry, are those markets.

We as an industry are vital to preserving and enhancing the integrity of the capital markets. We are the agents for the capital formation process. We are the vehicle for the savings and investment programs that will be critical to restoring our country's competitiveness internationally.

We perform a vital function in helping the Federal Government to meet its financing needs through our underwriting, distributing and making markets in securities of the U.S. Treasury and Government agencies.

The securities industry has been and continues to be vital, innovative and resourceful in creating new products to facilitate corporate and public finance. We have developed financing alternatives which had never previously existed. Without us, financing costs for all issuers would have been higher and more businesses and investors would have buckled under the way to post-Vietnam inflation.

Creativity and innovation have been the hallmarks of the industry and the reason that its survival and continued health are critical to our Nation's economy.

The long-term health of the securities industry, like that of any industry, depends on whether it adds value. The current problems faced by the securities industry should not obscure its achievements in the past decade. The financial alternatives provided by our industry have added and continued to add enormous value to America. The value has been added through risk-taking and innovation, commercial paper assets securitization and the creation of numerous derivative products to facilitate hedging and risk management.

Let me give you a few examples of the benefits of the securities industry as an innovative and competitive alternative.

The emergence of a new product like commercial paper allowed major corporations to borrow for 2 percent less than prime and pass the savings in loans to their customers.

When the post-Vietnam inflation skyrocketed and trapped the individual with modest funds in his interest rate controlled bank account, the money market fund came to his rescue and put him on a par with a very large CD buyer.

When depository institutions found themselves whip-sawed by the same surging inflation and wound up with fixed low interest mortgages and increasingly costly short-term funding, the innovation of the asset backed securities market was beneficial to many of them to help them get back on an even keel, and provided them with a way for getting their customers what they wanted—fixed rate mortgages, while avoiding interest rate shocks themselves by spinning the mortgages off into pools to be securitized.

I hope these few examples make my point. Without a separate healthy and independent securities industry, the cost of capital for issuers would be higher and the capital markets would be sluggish.

As securities firms across the country demonstrate every day, the securities and securities-related services that this Nation requires can be handled competently, free of government backing. And the failures in our industry, of which there have been too many lately, do not cost the American taxpayer 1 cent.

The strength and integrity of our capital markets are dependent on a strong and competent SEC with sufficient resources.

SIA is, therefore, most supportive of the SEC being self-funded from its own fees and activities rather than subject to the vagaries of the Federal budget process.

Moreover, we favor lifting the current pay caps imposed on the SEC that do not apply to other Federal regulatory agencies, such as the FDIC, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, so that the SEC can attract and retain the most competent personnel.

In that context, SIA needs to work with the subcommittee and the SEC to reduce the multiplicity of regulation by the various States, by the Federal Government and most recently by foreign regulators as a consequence of the globalization of the markets.

In an era where margins are as tight as ours, the cost of compliance with these overlapping regulatory schemes should not be a deterrent to capital formation. We must streamline the regulatory system and find a proper balance within it.

At the same time, SIA strongly supports the consolidation of Federal regulatory oversight of equities, equity options and equity index futures, in one agency—the SEC.

The transfer of jurisdiction over equity index futures to the SEC would go a long way toward helping reduce the market volatility, restore confidence of individuals in the capital markets and help to bring individuals back into the equity markets.

We also need to boost our savings in investment if our economy is to remain vital and competitive in the global arena.

In 1989, U.S. personal savings as a percentage of disposal income fell to 3.2 percent, the lowest figure since data became available in 1960. Our national savings rate is a small fraction of that of the United Kingdom, Germany or Japan. Already the low savings rate, heavy Government borrowing and high cost of capital have hurt investment in R&D and infrastructure and in our human resources through education and training programs.

We are eating into our capital, not building it. Across the Nation, there are outmoded and, in some cases, dangerous roads and rusting and corroding bridges. In many major cities, there are ruptured water mains and inadequate police, fire, and hospital facilities. Our public schools still contain inadequate facilities to the detriment of the current and the next generation.

The extent of illiteracy in America is shocking. In fact, our entire educational system from books to buildings is not providing the training to enable our children to be prepared for the 21st century.

American cities and municipalities in the States as well will have to increase their borrowing substantially in the marketplace to raise funds to repair these shortcomings. The securities industry will work with Government officials to make these indispensable infrastructure repairs and refittings acceptable to the public in a fiscally responsible fashion.

To accomplish this, a sensible and fair tax policy is sorely needed.

The United States has been consuming too much and investing too little. Our low savings rate and the resulting lack of funds is clearly hobbling expansion and capital-raising efforts of smaller companies thereby costing jobs. It also puts us at a competitive dis-

advantage inasmuch as our trading partners with higher savings rates can raise funds more cheaply.

A healthy growing economy is necessary to generate adequate savings in investment. The securities industry's traditional proposals in this area—capital gains reduction, elimination of double taxation of dividends, restoration of IRA's remain just as valid today as they were first proposed.

Another question which Congress urgently needs to address is how we are to provide for our aging population. A realistic national retirement policy must be implemented and the relationship between our national income policy and long-term savings and investment must be thoroughly explored.

The United States has become heavily dependent on foreign capital to fuel our economy and to fund our deficits. This capital is now being diverted to other markets at our expense. Further, U.S. investors are now targeting foreign markets for their investments. Funds that otherwise would be invested in our economy or in our own Government bonds.

This will mean higher cost to the United States for U.S. corporate and Government borrowing. Relative interest rates will remain higher than they would have been in the past in this country.

Overseas markets are benefiting much more than our domestic markets from the globalization of the securities markets. Opportunities in the European Community after1991, opportunities as Eastern Europe opens up and modernizes its various economies and opportunities in Asia are all attracting capital that formerly came to America.

This should be a major concern to us as new world markets evolve.

Of course, all our efforts to strengthen the U.S. economy will be made more difficult if our financial intermediaries are not healthy. The financial framework established by Congress in the 1930's has been progressively batted by the march of events and the action of regulators. The Federal Deposit Insurance System, originally intended to create safety and security for small savers, has become the vehicle for transferring the risks of bank and thrift activities to the American taxpayer.

The savings and loan fiasco grew out of the removal of restrictions on the activities of federally insured institutions in response to suggestions that expansion and diversification were essential to maintain their competitiveness.

Unshackling thrifts to use federally insured deposits for entrepreneurial activities turned out to be a recipe for disaster.

Last year at this time, SEC announced its conceptual proposal for financial service restructuring. We have now completed drafting specific language of our proposal entitled the Taxpayer Protection, Capital Markets Reforms and International Competitiveness Act. This document together with a section by section analysis is included as appendix B to my written testimony.

The fundamental precept underlying our proposal is that market discipline should be the regulator of wholesale securities and securities-related activities for commercial banking organizations as it is for securities firms.

These activities can and should be carried on by commercial banking organizations on a free market basis without government support.

Federal deposit insurance should not stand behind or be at risk from such activities. To this end, we have proposed the creation of a nonfederally insured national bank to support and service the domestic and international securities and securities-related activities of affiliates within the bank holding company structure.

This is critical because the temptation to poach upon the resources of an affiliated federally insured bank will be overwhelming unless there is an alternative source of credit support for these activities.

On the retail side, our plan contemplates that securities firms will be able to own retail insured banks to serve consumers, their families, and households. In this way, new management and new capital will be brought into the banking industry and these new retail insured banks will contribute premiums to the Bank Insurance Fund.

Similarly, federally insured banks within a bank holding company structure would be able to operate SEC registered broker-dealers to carry on retail securities brokerage activities on an agency basis.

Regulation would be strictly functional and without overlap. The SEC would regulate the securities affiliates of bank holding companies just as if those activities were being carried on by securities firms not affiliated with banks. The Comptroller of the Currency would regulate the nonfederally insured national bank and the appropriate banking regulator would regulate the retail insured bank subsidiary of a securities firm.

If the new structure we are suggesting is adopted and works as intended, it will be a key element to the reform required to safeguard the deposit insurance system.

The time has come for decisive action. If we don't bring about this change in 1991, then when?

Every day, we read about more layoffs in securities firms and other troubled banks, a higher estimate of the cost of the savings and loan bailout. Every day without financial restructuring costs American taxpayers more money.

As I have stated elsewhere, we need to have a financial summit to accomplish these objectives. SIA has sought to move the fate forward by reexamining and altering our long-held position of opposition to change and moving to one of development and sponsorship of a constructive change. By this action, SIA has demonstrated its commitment to resolving the problem of financial restructuring. We are still waiting for action from other groups in the private financial sector to enlarge this dialog.

I would urge you, Mr. Chairman, and other congressional leaders in cooperation with the administration and the appropriate regulators to bring together representatives from the private sector—banks, securities firms and other interested parties—in a financial summit. Let's lock ourselves in a room and thrash out a workable restructuring proposal.

It's in the interest of each of our industries to get the American financial system back on sound footing again. It is essential that we grasp this opportunity before it alludes us.

SEC stands ready and eager to assist in any way it can to deliberations of this subcommittee or of the Senate Banking Committee as a whole.

Once again, I thank you for this opportunity to present SIA's views and we'd be pleased to answer any questions that you may have.

[The complete prepared statement of Gedale B. Horowitz follows:]

42-559 O - 91 - 3

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SECURITIES SUBCOMMITTEE
UNITED STATES SENATE

HEARING ON THE CONDITION OF THE SECURITIES INDUSTRY
January 8, 1991

TESTIMONY OF

GEDALE B. HOROWITZ
CHAIRMAN
SECURITIES INDUSTRY ASSOCIATION

THE CONDITION OF THE SECURITIES INDUSTRY

EXECUTIVE SUMMARY

I am Dale Horowitz, Senior Executive Director of Salomon Brothers Inc. and am testifying in my capacity as Chairman of the Securities Industry Association. Thank you very much for the opportunity to participate in this hearing.

After a prolonged period of growth and profitability starting in the late 1970's and continuing up to 1987, the securities industry currently finds itself in a down cycle. Overcapacity occasioned by the long boom period has resulted, in the aftermath of the October 1987 market break, in significantly increased competition for seriously reduced amounts of business. Hence, for most securities firms today, spreads have become razor thin and profitability marginal.

In addition, the character of the business has changed. Diminution in agency commission revenues as a major component of income has led to increasing reliance on underwriting, merchant banking, and other transactions in which the securities firm accepts risks as principal. Today, two-thirds of the industry's revenue is risk-based. At the same time, the market has become ever more volatile as a consequence of a number of factors, including especially the globalization of the financial markets. In short, even though capital remains strong, the industry is currently experiencing the problems of overcapacity, high risk, and low returns.

Nevertheless, it must be remembered that the U.S securities industry has an unparalleled record in evolving capital-raising mechanisms to fund corporate growth and public improvements. The industry has been, and continues to be, vital, innovative, and resourceful in creating new products to facilitate corporate and public finance. The securities industry has also developed financing alternatives which never would have existed if there had not been a separate, strong, and independent securities industry; without such an industry, financing costs would have been higher, and more businesses and investors would have buckled under the weight of post-Vietnam inflation.

Creativity and innovation have been the hallmarks of the industry and the reason that its longer term prospects are bright and its continued health is critical to the nation's economic vitality. The securities industry has added value through risk-taking and innovation -- such as commercial

paper, asset securitization, and the creation of numerous derivative products to facilitate hedging and risk management. The result has been to create the world's finest capital markets here in the United States -- markets that have fueled America's economic growth and entrepreneurial spirit. And the failures in the securities industry, of which there have been too many lately, have not cost the American taxpayers one cent!

As the strength and integrity of our capital markets are dependent on a strong and competent SEC with sufficient resources, SIA supports the SEC being self-funded from its own fees and activities and supports as well lifting the pay caps imposed on the SEC. Moreover, SIA needs to work with this Subcommittee and with the SEC to reduce the multiplicity of regulation and streamline the regulatory system. SIA also supports transferring jurisdiction over stock index futures to the SEC.

In recent years, SIA has stressed the pressing need for higher levels of savings and investment in the United States, particularly in R&D, in infrastructure, and in human resources. Our nation is consuming too much and investing too little. Our low savings rate, the concomitant shortage of capital, and the decreasing availability of capital from abroad hobbles the ability of our smaller companies to raise financing, thereby costing jobs and placing the United States at a competitive disadvantage vis-a-vis our trading partners with higher savings rates and lower costs of funds. SIA's traditional proposals in this area -- capital gains reduction, elimination of double taxation on dividends, restoration of IRAs -- remain just as valid today as when they were first proposed. In addition, we as a nation need to address the question of how we are to provide for our aging population and to explore the relationship between our national retirement policy and long-term savings and investment.

The United States has become heavily dependent on foreign capital to fuel our economy and to fund our deficits, but some of this capital is now being diverted to other markets at our expense. Opportunities in the EC after 1992, in Eastern Europe, and in Asia are all attracting capital which formerly came to America. SIA strongly endorses the efforts of the U.S. Trade Representative and the Treasury Department to open these markets.

We must ensure that any financial restructuring undertaken to meet the threat from abroad does not cost the taxpayers any additional money. The financial framework established by Congress in the 1930's has been progressively battered by the march of events and the actions of regulators. The federal deposit insurance system, originally

intended to create safety and security for small savers, has become the vehicle for transferring the risks of bank and thrift activities to the American taxpayer. Now that the commercial banking industry, in addition to the thrift industry, has fallen on hard times, and needed financial services to individuals, families, and households are suffering as a consequence, any plan of restructuring and deposit insurance reform must consider how additional capital may be brought to the service of consumers without adding unnecessary and unacceptable risk to the deposit insurance system.

SIA has worked for the better part of two years to evolve the approach embodied in our legislative proposal, "The Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act," which we released last month. SIA's plan would arrest the expansion of risks borne by the deposit insurance system by removing from insured banks those activities which do not require the support of federal deposit insurance.

The fundamental precept underlying our proposal is that market discipline should be the regulator of "wholesale" securities and securities-related activities for commercial banking organizations as it is for securities firms. Federal deposit insurance should not stand behind, or be at risk from, such activities. To this end, we have proposed the creation of a nonfederally insured national bank to support and service the domestic and international securities and securities-related activities of affiliates within the bank holding company structure. This is critical, because the temptation to poach upon the resources of an affiliated federally insured bank will be overwhelming unless there is an alternative source of credit support for these activities.

On the retail side, our plan contemplates that securities firms will be able to own retail insured banks to serve consumers, their families and households. In this way, new management and new capital will be brought into the banking industry, and these new retail insured banks will contribute premiums to the Bank Insurance Fund. Similarly, federally insured banks within a bank holding company structure would be able to operate SEC-registered broker-dealers to carry on retail securities brokerage activities on an agency basis.

Regulation would be strictly functional and without overlap: the SEC would regulate the securities affiliates of bank holding companies just as if those activities were being carried on by securities firms not affiliated with banks; the Comptroller of the Currency would regulate the nonfederally insured national bank; and the appropriate banking regulator

would regulate the retail insured bank subsidiary of a securities firm. If this proposed new structure is adopted and works as intended, it will be a key element of the reform required to safeguard the deposit insurance system.

We need to have a financial "summit" to accomplish these objectives, and so SIA urges Congressional leaders, in cooperation with the Administration and appropriate regulators, to bring together representatives from the private financial sector to thrash out a workable restructuring proposal that makes sense for America.

0898f

TESTIMONY

On behalf of the Securities Industry Association, I would like to thank the Chairman and the Subcommittee for the opportunity to participate in this hearing on the condition of the securities industry.

I am Dale Horowitz, Senior Executive Director of Salomon Brothers Inc., an international investment banking firm headquartered in New York City. I am here in my capacity as chairman of the Securities Industry Association.

SIA represents approximately 600 firms active in the securities business. SIA's members range from large firms engaged in a full spectrum of domestic and international securities and securities-related activities to small firms engaged exclusively in retail brokerage. Our membership accounts for more than 90 percent of securities activities in North America.

I would like first to comment on the general condition of the securities industry at present. Then I would like to review what I believe have been the benefits to the United States of a system providing securities intermediaries as a financial alternative. Finally, I will outline the concerns I believe we should have in mind as we look to how the United States should reorganize its financial system for the years ahead in an ever more closely interconnected world. Appendix A to this testimony supplements with statistical information the discussion in this testimony about the growth of the industry in recent years and the difficulties it now faces.

CURRENT STATE OF THE INDUSTRY

Over the past few weeks, it has been widely acknowledged that late last year the U.S. economy, particularly in certain regions, entered its first recession since the early 1980s. There have also been forecasts that this recession will be mild and short lived - July being the predicted turnaround date by some observers.

We at SIA certainly hope this to be true since, as you know, the securities industry has just begun its fourth year of recession, and it has been anything but mild and may continue on long past July.

Through the third quarter of last year, the securities industry barely broke even. Profit margins (profits as a percent of gross revenue) were less than one-tenth of one percent before taxes, while pre-tax return on equity was under 1%. This is the lowest profitability our industry has experienced since 1974 and preliminary fourth quarter results predict a net loss for the year, which would make 1990 the first full-year loss for the securities industry since 1973.

The long-term profitability trend of the securities industry has been one of steadily declining margins for many years, even during the relatively "good times" of the early-to-mid 1980s. As the accompanying exhibits graphically illustrate (see Exhibit 1, Profit Margins), in spite of the aggregate growth of the securities business, profit margins have been steadily whittled down over the last 25 years to roughly a nickel per dollar of revenue, before taxes, and, as mentioned, the industry will likely post a loss for 1990 with little good news on this year's horizon, either.

Barriers to entry in our business are low while competition is fierce. Just 10 years ago (1980), there were slightly over 5,000 securities firms, mainly small, reporting to the SEC. By 1987, just prior to the October market crash, this number had doubled to nearly 10,000, although it has declined somewhat since. Recent relaxation of the separation between investment banking and commercial banking has augmented competitive pressures to the point where the industry has overcapacity in many business lines. Quite frankly, competition and overcapacity in the securities business have reached a level that mirrors one of the perennial problems of the commercial banking industry - there is just not enough business to support the number of firms competing for it.

After the 1987 stock market crash, when the industry's health rapidly declined, the industry began to pare back and jobs were the first to go. In the three years since the crash, employment was cut by at least 48,000 or by 18% (see Exhibit 2, Shrinking Employment) through this past September. Additional layoffs have continued to proliferate in the past three months and more will probably continue this year. Harvard professor Sam Hayes summed it up in the New York Times when he observed that before the employment figures stabilize, "there will be a lot of blood on the floor."

Nonetheless, Professor Hayes believes that our industry will emerge from this cycle. When this happens, he says "Wall Street will be back on a normal growth trend."

Yet there remain some other negative signs for our industry. Roughly one-third to one-half of all New York Stock

Exchange (NYSE) member firms have posted red ink each quarter since the market crash of 1987. On the bright side, however, capital in the industry remains strong: the total capital of New York Stock Exchange member firms was more than $36 billion as of September 1990.

The industry's traditional core business, agency commissions, now represents less than 17% of total revenues (see Exhibit 3, Commissions Share). Principal transactions, involving principal risk, have mushroomed. The securities industry has long been known as an industry of risk-takers, but that term is more apt today than ever. Today, two-thirds of the industry's revenue base is risk-based (trading, underwriting, investment and merchant banking, etc.) (See Exhibit 4, Altered Revenue).

There is a very direct connection between the health and performance of the securities industry and the well-being of the United States. The American capital markets are the engines for our economy's growth and development, and we, as an industry, are those markets.

We, as an industry, are vital to preserving and enhancing the integrity of the capital markets. We are the agents for the capital formation process. We are the vehicle for the savings and investment programs that will be critical to restoring our country's competitiveness internationally.

The 1980s saw a significant increase in the volume of financing brought to the capital markets by the securities industry as well as the introduction of many new financing techniques. Annual debt offerings went from less than $50 billion in the early 1980s to nearly $300 billion last year (Exhibit 5, Underwritten Debt). This financing level continues at record levels despite our industry's recent problems. The fastest growing debt underwritings are those of an innovative product of the 1980s - asset backed bonds. These bonds account for about $2 out of every $3 sold by corporate America and represent the repackaging or securitization of home mortgages, credit card receivables, auto and truck loans, etc. In effect, these loans have been taken off the books of banks and other financial institutions and securitized and sold to institutional investors, thereby freeing up capital for new loans.

The 1980s saw many other innovative financing techniques, such as variable interest rate bonds with "puts" and "multi-mode" instruments developed to permit state and local government issuers to take advantage of either short-term or long-term interest rates, but the list is too exhaustive to cover here.

The equity markets were not a major source of financing for corporations in the 1980s, nor has the start of a new decade changed that trend. If closed-end mutual funds are not considered, raising risk capital for new companies via initial public offerings (IPOs) has been virtually non-existent. After peaking at $18 billion in 1986 and then falling to $14 billion in 1987 due to the market crash's impact on that year's tally, "true" IPOs raised only about $6 billion annually over the past three years (Exhibit 6, True IPOs). This $6 billion level is just slightly higher than the very modest levels for the early 1980s.

In the early 1980s, equities accounted for about 30% to 50% of all public new issues. Last year, it was less than 10%. In dollars, equity offerings peaked in 1986-87 period with over $70 billion offered annually, most of which was offered to the general public through SEC registered underwritings (Exhibit 7, New Equity). However, for the past few years, only half that amount was raised annually and now only half of all new equity is underwritten to the general public with the balance privately placed. The small amounts of new equity issues contrast sharply with approximately $500 billion in equity "removed" from the markets the past five years through M&A activity and corporate buybacks. Indeed, the long-term policy implications of a diminution in public equity offerings have yet to be comprehensively assessed.

While over $3 trillion was raised in the 1980s in the corporate capital markets, over $1 trillion in new long-term bonds were underwritten for state and local governments during the 1980s, the vast majority by securities firms. Nevertheless, activity in the municipal area dropped sharply from levels reached in 1985-86 (see Exhibit 8, Municipal Bond). Much of this drop has to do with the Tax Reform Act of 1986, which curtailed many types of municipal offerings and negatively affected investor demand for tax-exempt instruments. In 1989, however, $660 billion was raised in the capital markets for corporations and local governments.

Moreover, the securities industry has helped the federal government raise necessary capital by underwriting, distributing, and market-making in securities of the U.S. Treasury and federal government agencies.

THE LONG TERM OUTLOOK FOR AND VALUE OF AN INDEPENDENT SECURITIES INDUSTRY

The long-term health of the securities industry -- like that of any industry -- depends on whether it adds value. The

current problems faced by the securities industry should not obscure its achievements in the past decade. The financial alternatives provided by our industry have added, and continue to add, enormous value to America. That value has been added through risk-taking and innovation -- commercial paper, asset securitization, and the creation of numerous derivative products to facilitate hedging and risk management.

When one looks at the success of capital-raising mechanisms to fund corporate growth and public improvements, no country's record compares with that of the United States. The action Congress took in 1933 to separate traditional commercial banking from the risk-taking of the securities industry has turned out to be an act of genius for capital formation in the United States and, beginning after World War II, in Japan. Money has been raised and in the process, ownership of corporate assets has been dispersed; entrepreneurship has flourished and consumers have benefited from lower-cost goods due to lower-cost financing by the producers of goods.

The traditions of the United States have included diversity of financial choice and of discouraging concentrations of financial power; private sector financial markets; and the absence of governmental ownership of economic and financial institutions. These traditions have been good for America and the question now is whether we can continue them in the future.

Let me give a few examples of the benefits of an independent securities industry as an innovator and competitive alternative. The emergence of a new product like commercial paper allowed major corporations to borrow for two percent less than prime and pass the savings along to their customers. When post-Vietnam inflation skyrocketed and trapped the individual with modest funds in his interest rate-controlled bank account, the money market fund came to his rescue and put him on a par with the very large CD buyer. When depository institutions found themselves whipsawed by the same surge in inflation and wound up with fixed, low-interest mortgages and increasingly costly short-term funding, the invention of the asset-backed securities market saved many of them. It helped them get back on an even keel and provided them with a way to keep giving their customers what they wanted -- fixed-rate mortgages -- while avoiding interest-rate shocks themselves by spinning the mortgages off into pools to be securitized.

I hope these few examples make my point: had there not been a separate and independent securities industry, corporate finance would have been more expensive, and more small investors would have buckled under the weight of post-Vietnam inflation.

Our industry has helped create the world's finest capital markets here in the United States -- liquid, open and honest markets. Despite our nation's tough disclosure requirements, many foreign companies come to America to raise money. Foreign investors have long flocked to our markets with a confidence they had nowhere else. We have fueled the American entrepreneurial spirit. We are a creative and inventive industry that has developed financing alternatives that never previously existed. Without the competition provided by the securities industry, financing costs would be higher for issuers and capital markets would be sluggish. As securities firms across the country demonstrate every day, the securities and securities-related services that this nation requires can be handled competently, free of any government backing. And the failures in our industry, of which there have been too many lately, do not cost the American taxpayers one cent!

In light of the contributions past and present of the securities industry, as well as its current and future condition, we must address some important questions as we enter the '90s:

- What role should the SEC and regulation play in this coming decade?
- How do we encourage the savings and investment so critical for our nation's future?
- How do we protect and enhance the integrity and competitiveness of the American financial markets while other jurisdictions have less demanding regulatory frameworks?
- How can we allow our commercial banking organizations to participate in greater securities and securities-related activities without adding unacceptable risk to the federal deposit insurance system and the American taxpayers?
- What should the architecture of financial restructuring be? The Glass-Steagall Act has been the order of the day in America from 1933 until 1987 when banking regulators started dismantling it on their own. Must not Congress act to provide for international competitiveness of our financial institutions while protecting taxpayers?

While these questions are all somewhat interrelated, I would like to address them each briefly.

THE SEC AND REGULATION

The strength and integrity of our capital markets are dependent on a strong and competent SEC with sufficient resources. We are therefore most supportive of the SEC being self-funded from its own fees and activities rather than subject to the vagaries of the federal budget process. Moreover, we favor lifting the current pay caps imposed on the SEC that do not apply to other financial regulatory agencies such as the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, so that the SEC can attract and retain the most competent personnel.

a. Multiple Regulation

In that vein, we need to work with the SEC and the Subcommittee to reduce the multiplicity of regulation. Multiplicity of government regulation provides a never-ending deterrent to capital formation. The Byzantine and often obsolete regulations we must adhere to are guaranteed to keep our compliance people employed no matter what other cutbacks we may have to make. And, as if state and federal regulators weren't enough, the globalization of the markets has put us within the jurisdiction of yet another set of regulators. That's three levels of regulation and that is simply too much. It's not an efficient use of either our industry's or our government's resources. The greater expenses of over-regulation are borne ultimately by the individual investor. We must streamline the regulatory system.

One of the securities industry's biggest concerns is state regulation. State regulators are taking a more aggressive role. But, as SEC Chairman Breeden pointed out in his speech last November at the University of Nebraska:

> "We must find ways to reduce the duplication and unnecessary cost and delay represented by the various state securities laws. The states have a very strong record in attacking fraudulent practices, yet the barrier to liquidity of multiple filing requirements in dozens of states is of questionable desirability today."

b. Regulation Over Equity Index Futures

The SIA also strongly supports granting jurisdiction over the one equities market -- comprised of equities, equity options and equity-index futures -- to one regulator, the SEC. The transfer of jurisdiction over equity index futures only to the SEC would go a long way toward helping to reduce market

volatility, restore confidence of individuals in the capital markets, and help to bring individuals back into the equities markets.

SAVINGS AND INVESTMENT

In recent years, the SIA has been stressing the need for higher levels of savings and investment in the U.S. We need to boost our savings and investment if our economy is to remain vital and competitive in the global arena.

The naked statistics are most telling:

- In the 1970s, our national savings rate was 53 percent of Europe's, 31 percent of Japan's.
- In 1985, one study showed further deterioration: the U.S. savings rate was less than half those of the U.K. and Germany and less than a quarter of Japan's.
- Then in 1989, U.S. personal savings as a percentage of disposable income fell to 3.2 percent, the lowest figure since data became available in 1960! Today the rate remains under 5 percent.

Some argue that the savings rate will improve in the 1990s, but those predictions usually hinge on an assumption of growth in the real wages of baby boomers. We cannot "bet the ranch" on that assumption.

Already, the low savings rate, heavy government borrowing, and high cost of capital have hurt investment in R&D, in infrastructure, and in our human resources through education and training programs. We are eating into our capital, not building it.

Across the nation there are outmoded -- and in some cases dangerous -- roads and rusting and corroding bridges. In virtually every major city there are ruptured water mains and inadequate police, fire, and hospital facilities. Our public schools still contain inadequate facilities to the detriment of the next generation. The extent of illiteracy in America is shocking. In fact, our entire educational system, from books to buildings, is not providing the training to enable our children to be prepared for 21st Century competition.

American cities and municipalities, and the states as well, will have to increase their borrowings substantially in the marketplace to raise funds to repair these shortcomings. The securities industry will work with government officials to

make these indispensable infrastructure repairs and refittings acceptable to the public in a fiscally responsible fashion. To accomplish this, a sensible and fair tax policy is sorely needed.

Now the problem threatens to become worse. The world economy faces a shortage of capital. Eastern Europe and Latin America will both need massive infusions of capital during the '90s. The situation in the Persian Gulf could require many billions of dollars before it is resolved. And our economy has entered a recession.

The United States has been consuming too much and investing too little. Our low savings rate and the resulting lack of funds is clearly hobbling expansion and capital-raising efforts of smaller companies, thereby costing jobs. It also puts us at a competitive disadvantage inasmuch as our trading partners with higher savings rates can raise funds more cheaply.

A healthy, growing economy is necessary to generate adequate savings and investment. The securities industry's traditional proposals in this area -- capital gains reduction, elimination of double taxation of dividends, restoration of IRAs -- remain just as valid today as they were when they were first proposed, but they have not yet been enacted. Budget and tax-driven discussions put us on the defensive about costs and equity. Economic growth as a rationale has not generated enough momentum to change the situation.

Another question which Congress urgently needs to address is how we are to provide for our aging population. A realistic national retirement policy must be implemented, and the relationship between our national retirement income policy and long-term savings and investment must be thoroughly explored.

In short, economic growth and social concerns are not unrelated subjects but are inextricably intertwined. We must all more closely examine these issues to raise the level of public debate, bring in more participants, and give a broader focus and framework to the SIA's proposals to increase savings and investment -- proposals which are in the country's best interests.

INTERNATIONAL CONCERNS

The United States has become heavily dependent on foreign capital to fuel our economy and to fund our deficits. This capital is now being diverted to other markets at our expense. Further, U.S. investors are now targeting foreign markets for

their investments - funds that otherwise would be invested in our own economy or in our own government bonds. This will mean higher costs of U.S. corporate and government borrowing. Interest rates will remain much higher than they would have been in the past in this country.

U.S. investor appetite for foreign stocks has soared since 1988 (Exhibit 9, U.S. Net Purchases of Foreign Stocks) and last year these investors also more than doubled their net purchases of foreign bonds (Exhibit 10, U.S. Net Purchases of Foreign Bonds). If this is combined with the current net sell-off of U.S. securities by foreigners (Exhibit 11, Foreign), the actual net outflow of capital from securities transactions last year becomes a matter of concern because this is the first time in recent memory such a net outflow has occurred (Exhibit 12, Net Portfolio Flows).

Overseas markets are benefiting much more than our own domestic markets from the globalization of the securities markets (Exhibit 13, Trading). Opportunities in the EC post-1992, opportunities as Eastern Europe opens up and modernizes its various economies, opportunities in Asia, etc., are all attracting capital that formerly came to America. This should be a major concern to us as newer world markets evolve.

With respect to the major securities markets -- Europe and Japan -- access by U.S. securities firms has improved greatly. Currently, we are not experiencing problems in access to the European markets. The EC has seen a tremendous upsurge in competition in the securities business and currently there are too many participants. Much business is unprofitable as many market participants chase market share with below break-even pricing. However, for those American firms which pick those slots carefully, even the EC today can be a profitable place to do business.

As far as Japan is concerned, most major U.S. securities firms believe that progress is being made toward opening up that market to overseas competitors. Indeed, in some respects American securities firms currently enjoy advantages which domestic securities firms do not. Some major American firms are operating quite profitably in Tokyo. There is an appetite for American innovation and dealing in derivatives has been profitable. The kind of tailoring that has become the hallmark of American financial markets appears most welcome in Japan. We believe it is important that such progress continue in the months ahead.

It is interesting to note that the major thrust of the recent round of GATT negotiations, at least insofar as they treat the financial services industries, has been directed not

so much at the EC or even Japan but at opening up Third World markets. Many of these markets are completely closed to U.S. financial firms. Thus, while the U.S. has generally had a policy of "unconditional national treatment" such that any foreign firm may compete in the U.S. markets subject only to the same constraints which we place on a similarly situated domestic firm, that has not been the case in many of these foreign markets, where there is no such thing as a two-way street. And while these markets are not now significant in terms of the volume or sophistication of transactions, they are located in nations which account for the vast majority of the world's population and therefore can be expected to grow in importance as we move into the 21st century. SIA therefore strongly endorses the efforts of the Office of the U.S. Trade Representative and the U.S. Treasury to open Third World markets.

As globalization of the financial markets continues, we face more serious competitive challenges from abroad. Recent developments in Europe, particularly the move toward a common European market, EC 1992, have focused our attention on the need to keep both our capital markets and our financial intermediaries competitive internationally. And, coupled with current economic conditions, we must ensure that any financial restructuring undertaken to meet the threat from abroad does not cost the American taxpayer any additional money.

68

FINANCIAL RESTRUCTURING AND DEPOSIT INSURANCE REFORM

In his introduction to President Bush's 1991 budget, OMB Director Darman warned of the $3 trillion contingent liability hanging like the sword of Damocles over the federal government and taxpayers with respect to banking and other organizations backed by the United States. Yet, notwithstanding the overcapacity, the risk-taking, the losses in revenues and the unemployment I have already mentioned, the independent securities industry has not cost the taxpayers one penny.

The exposure of the federal government to liability from securities and securities-related activities in general has been limited until relatively recently by the Glass-Steagall Act. Two developments have changed that situation. First, one securities-related activity in particular that was considered safe in 1933 -- dealing in foreign exchange -- has become a high-risk venture because of new volatility in the currency markets and the rise of speculative foreign exchange trading. Second, federal banking regulators have opened up gaping loopholes in the Glass-Steagall Act to permit securities activities by federally insured banks and by their subsidiaries

and affiliates. Some affiliates of federally insured banks are now authorized to deal in junk bonds. Indeed, Drexel's collapse was viewed by commercial banking organizations as a great opportunity to raid Wall Street firms for junk bond traders.

Certainly, the securities industry is having severe problems. However, in the United States, the most significant development of the '80s in the financial sector was the stupendous collapse of the thrift industry. The current cost to taxpayers has been estimated in excess of $500 billion, and the ultimate cost is still being estimated. To put this in perspective, the entire Marshall Plan to rebuild postwar Europe, in current dollars, cost the U.S. taxpayer $65 billion.

The savings and loan fiasco grew out of the removal of restrictions on the activities of federally insured institutions in response to suggestions that expansion and diversification were essential to maintain their competitiveness. There is an uncomfortable sense of deja vu in the current clamor for the "unshackling" of U.S. commercial banks. Unshackling thrifts for entrepreneurial activities while allowing them to use federally insured monies turned out to be a recipe for disaster for Congress and the nation's taxpayers.

We must learn from history, so as not to repeat it.

Last year at this time, SIA announced its conceptual proposal for financial services restructuring. We have now completed drafting the specific language of our proposal, entitled "The Taxpayer Protection, Capital Markets Reform and International Competitiveness Act." This document, together with a section-by-section analysis thereof, is included as Appendix B.

SIA's draft legislation is a working document. The legislation, as its title implies, seeks to protect the taxpayer, keep the U.S. capital markets open, competitive, and free, and yet make it possible for U.S. commercial banking organizations to operate more flexibly both domestically and internationally. The Act focuses on securities and securities-related businesses and banking as areas most urgently needing attention. If the new structure provided for in the Act is adopted and works as intended, it will be a key element of the reform required for safeguarding the deposit insurance system. In short, restructuring is integral to federal deposit insurance reform.

The basic premise of the Act is that wholesale securities and securities-related activities can and should be carried on by commercial banking organizations on a free market basis without government support, and that federal deposit insurance should not stand behind, or be at risk from, such activities.

There is no reason why American taxpayers should -- and every reason why they should not -- be the ultimate insurer of losses in the securities and securities-related business of a commercial banking organization. SIA's draft legislation eliminates the need for a "too big to fail" doctrine that would bail out any part of a a commercial banking organization other than a federally insured bank or thrift. It reduces the risks borne by federally insured banks and recognizes that all federally insured banks -- not just the big ones -- are "too important to fail." Consequently, the competitive disadvantage experienced by smaller commercial banking organizations would be eliminated.

The times demand dramatic changes. SIA's plan accomplishes two seemingly contradictory objectives for commercial banking organizations:

- Separates the wholesale securities and securities-related activities of a commercial banking organization from its federally insured banks, thus reducing risks for the federally insured banks, the Bank Insurance Fund and the American taxpayer; and

- Provides a commercial banking organization with expansive securities powers to operate in tandem with its credit activities for international competitiveness.

Achieving both goals is made possible by the creation of a new entity. A bank holding company is authorized to establish nonfederally insured national banks known as investment banking financing companies (IBFCs), which in turn can own "qualified securities subsidiaries" carrying on all of the domestic and foreign wholesale securities and securities-related activities of the commercial banking organization (all underwriting, placing and trading of securities, permitted commodities and foreign exchange dealing not linked to customer trade needs, for example). The securities subsidiaries will include SEC-registered broker-dealers. The use of the separate subsidiaries facilitates functional regulation: the IBFC will be chartered and regulated by the Comptroller of the Currency, and the securities subsidiaries will be regulated by the SEC, the CFTC or otherwise, as appropriate. The IBFC and its securities subsidiaries (collectively, the "IBFC securities group"), will be able to operate with complete synergy. However, the IBFC securities group can have no direct or indirect contact with or support from any affiliated federally insured banking unit.

In recent statements, FDIC Chairman Seidman and Under Secretary of the Treasury Glauber have each addressed the desirability of shifting riskier activities out of federally

insured banks. This is the essence of the solution which the SIA suggested one year ago: privatize as much of commercial banking as possible, make it subject to market discipline and prevent it from raiding the resources of any affiliated federally insured unit. The temptation to poach upon the resources of an affiliated federally insured bank will be overwhelming unless there is an alternative source of credit support for the privatized activities. SIA's nonfederally insured IBFC is the alternative which removes that temptation.

Moreover, the plan contemplates that securities firms would be able to own federally insured retail banks to serve the families and households of America. With securities firms' ownership of federally insured retail banks, new management and new capital would be brought into the banking industry. These new retail banks would also contribute premiums to the Bank Insurance Fund. Consumers of banking services would benefit from new capital and competition in retail banking.

SIA's legislative proposal, responding to the concerns raised by the savings and loan disaster and the current, well-publicized problems in the commercial banking industry, is specifically designed to reduce the risk to the federal deposit insurance system and the American taxpayer; to improve retail banking services available to families and households; to provide new management and capital for federally insured retail banking services; to add premium flow to the federal deposit insurance system; to allow greater participation of commercial banking organizations in the wholesale securities markets; to permit nonfederally insured deposit taking, lending and wholesale securities activities to be conducted on an integrated basis; to preserve the integrity of our capital markets through avoidance of competitive distortions based on government subsidization of certain participants; and to increase investor protection through appropriate regulation and supervision.

The reorganization within a bank holding company family provided for in the Act responds to the crisis building within the commercial banking industry. A commercial banking organization acquires enormous flexibility in bringing together credit, securities and securities-related activities while, at the same time, the risks to the Bank Insurance Fund and the taxpayer are reduced, not increased. The IBFC securities group will follow normal accounting principles, so as activities and assets are transferred to the IBFC and its subsidiaries a picture more reflective of market realities is created, to the benefit of all concerned.

Allowing a securities firm to form an IBFC -- which will have no access to the Federal Reserve to support its securities and securities-related activities and no backing from the Bank Insurance Fund -- will lead the way to a privatized commercial

banking system, something the U.S. has not had in decades. In addition, when the crisis surrounding the Bank Insurance Fund and commercial banking organizations and their federally insured banks has subsided -- assuming a reorganization such as that proposed by the SIA plan takes place -- the need for the Bank Holding Company Act and the accompanying regulatory regime may well disappear over time. In the interim, the Federal Reserve Board can function as an additional line of defense in protecting bank holding company-owned federally insured banks from being raided by their entrepreneurial affiliates.

SIA's draft proposal carries out in some detail the concept announced last year by SIA, and we believe it accomplishes the objectives that we set forth then. The SIA's membership firmly believes that this approach is best for the taxpayer, best for the capital markets, best for domestic and international competition, and best for both commercial banking organizations and securities firms.

The time has come for decisive action. If we don't bring about these changes in 1991, then when? Every day we read about more layoffs in securities firms, another troubled bank, a higher estimate of the cost of the savings and loan bailout. Every day we don't provide incentives for savings, our roads and bridges continue to crumble. Every day without financial restructuring costs American taxpayers more money.

As I have stated before, we need to have a financial "summit" to accomplish our objectives. I would urge you, Mr. Chairman, and other Congressional leaders, in cooperation with the Administration and the appropriate regulators, to bring together representatives from the private financial sector -- banks, securities firms, and other interested parties -- in a financial "summit". Let's lock ourselves in a room and thrash out a workable restructuring proposal. It's in the interest of each of our industries to get the American financial system back on sound footing again.

SIA stands ready and eager to assist in any way it can the deliberations of this Subcommittee, or of the Senate Banking Committee as a whole. Thank you very much.

0895f

APPENDIX A

EXHIBIT 1

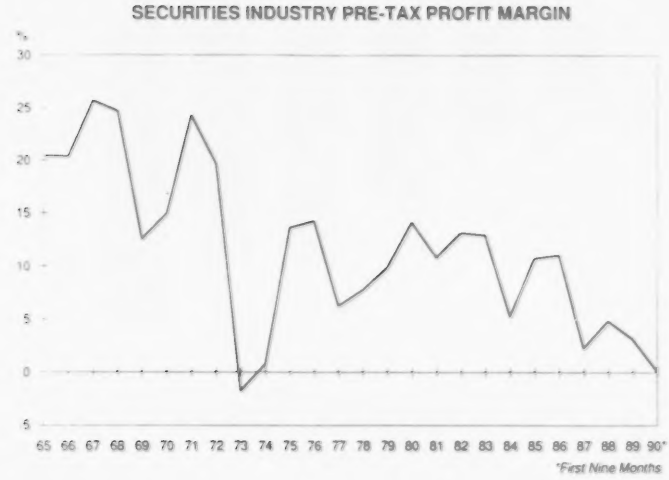


EXHIBIT 2

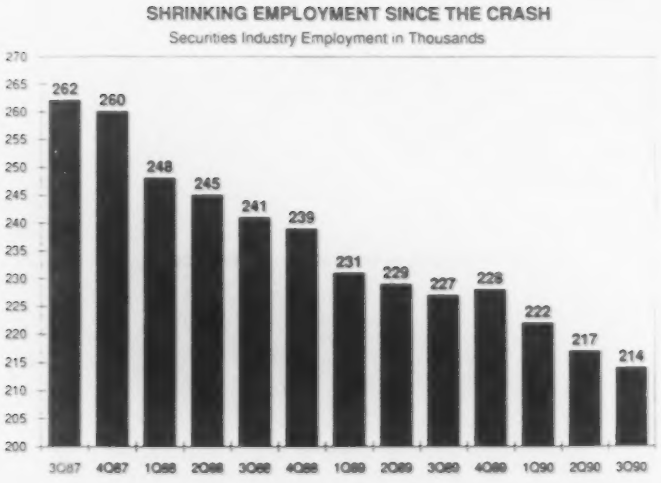

SHRINKING EMPLOYMENT SINCE THE CRASH
Securities Industry Employment in Thousands
270
265
260
255
250
245
240
235
230
225
220
215
210
205
200
262
260
248
245
241
239
231
229
227
228
222
217
214
3Q87
4Q87
1Q88
2Q88
3Q88
4Q88
1Q89
2Q89
3Q89
4Q89
1Q90
2Q90
3Q90

EXHIBIT 3

COMMISSIONS SHARE OF INDUSTRY REVENUES

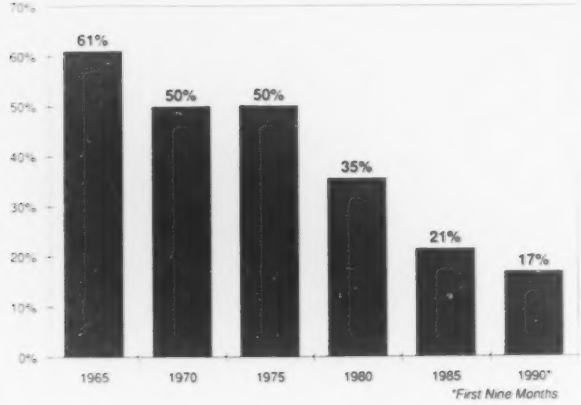


EXHIBIT 4

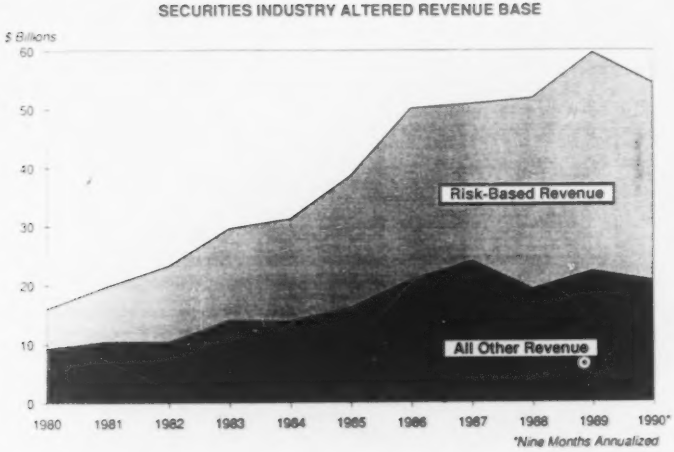

SECURITIES INDUSTRY ALTERED REVENUE BASE
$ Billions
60
50
40
30
20
10
0
Risk-Based Revenue
All Other Revenue
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990*
*Nine Months Annualized

EXHIBIT 5

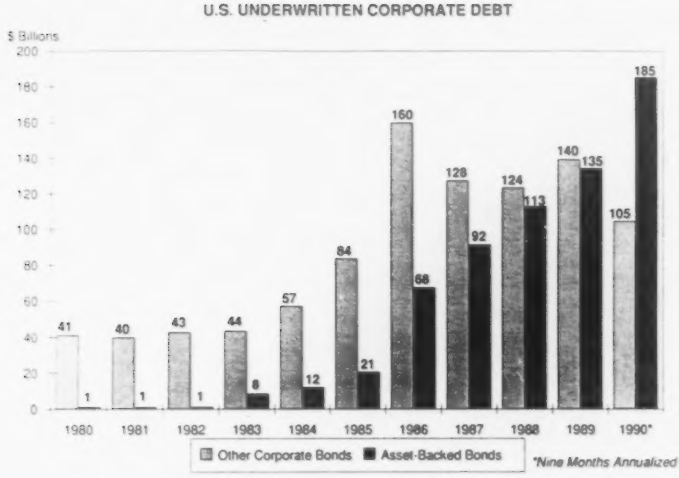

U.S. UNDERWRITTEN CORPORATE DEBT
$ Billions
200
180
160
140
120
100
80
60
40
20
0
41
1
40
1
43
1
44
8
57
12
84
21
160
68
128
92
124
113
140
135
105
185
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990*
Other Corporate Bonds
Asset-Backed Bonds
*Nine Months Annualized

EXHIBIT 6

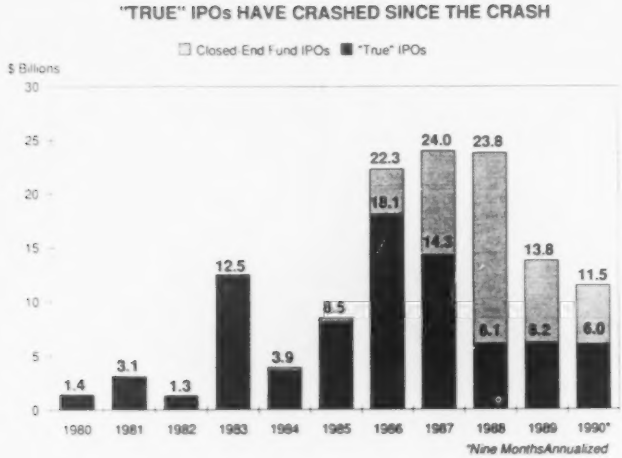

"TRUE" IPOs HAVE CRASHED SINCE THE CRASH
Closed-End Fund IPOs
"True" IPOs
$ Billions
30
25
20
15
10
5
0
1.4
3.1
1.3
12.5
3.9
8.5
22.3
18.1
24.0
14.3
23.8
6.1
13.8
8.2
11.5
6.0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990*
*Nine MonthsAnnualized

EXHIBIT 7

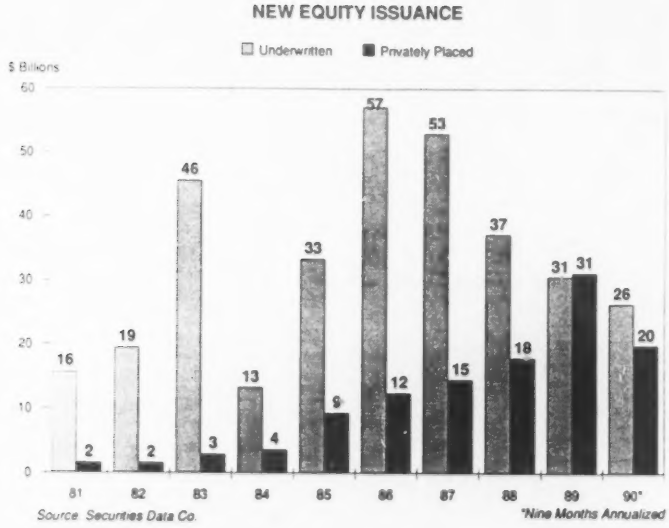

NEW EQUITY ISSUANCE
Underwritten
Privately Placed
$ Billions
60
50
40
30
20
10
0
16
2
19
2
46
3
13
4
33
9
57
12
53
15
37
18
31
31
26
20
81
82
83
84
85
86
87
88
89
90*
Source: Securities Data Co.
*Nine Months Annualized

EXHIBIT 8

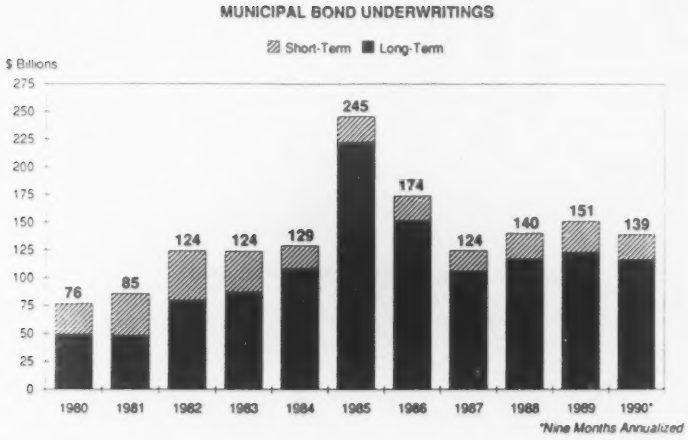

MUNICIPAL BOND UNDERWRITINGS
Short-Term
Long-Term
$ Billions
275
250
225
200
175
150
125
100
75
50
25
0
76
85
124
124
129
245
174
124
140
151
139
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990*
*Nine Months Annualized

EXHIBIT 9

U.S. NET PURCHASES OF FOREIGN STOCKS SURGE
$ Bils.
16
14
12
10
8
6
4
2
0
2
4
'80
'81
'82
'83
'84
'85
'86
'87
'88
'89
I-III90

EXHIBIT 10

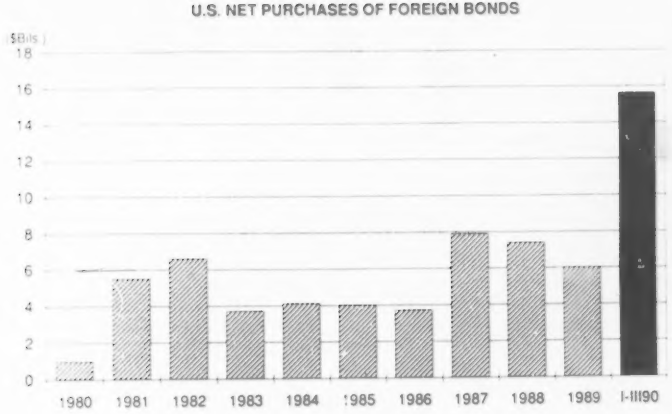

U.S. NET PURCHASES OF FOREIGN BONDS
($Bils.)
18
16
14
12
10
8
6
4
2
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
I-III90

EXHIBIT 11

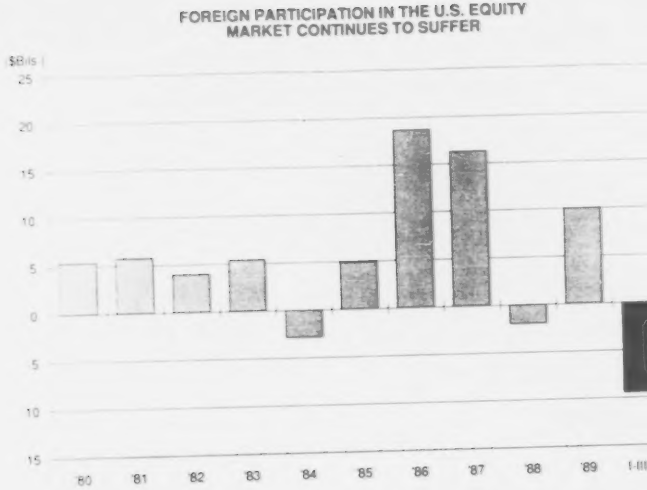

FOREIGN PARTICIPATION IN THE U.S. EQUITY MARKET CONTINUES TO SUFFER
($Bils.)
25
20
15
10
5
0
5
10
15
'80
'81
'82
'83
'84
'85
'86
'87
'88
'89
I-III

EXHIBIT 12

NET PORTFOLIO INVESTMENT:
U.S. CAPITAL NEEDS SUFFER

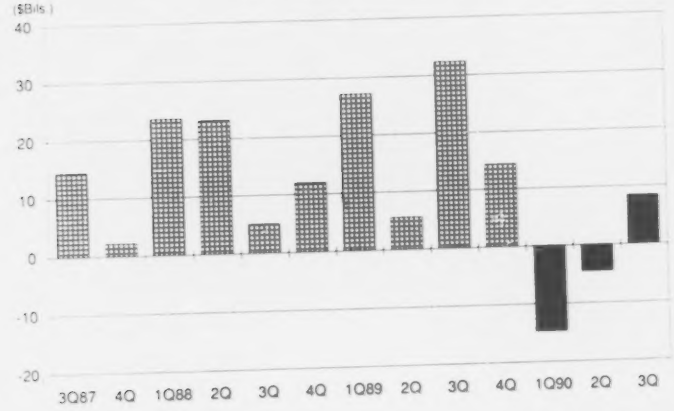
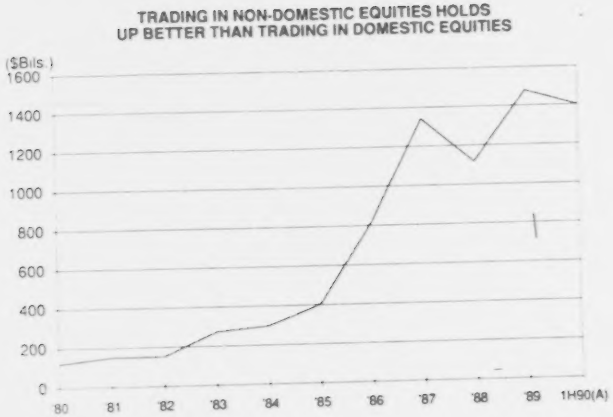


EXHIBIT 13


TRADING IN NON-DOMESTIC EQUITIES HOLDS
UP BETTER THAN TRADING IN DOMESTIC EQUITIES
($Bils.)
1600
1400
1200
1000
800
600
400
200
0
'80
'81
'82
'83
'84
'85
'86
'87
'88
'89
1H90(A)

APPENDIX B

SECTION BY SECTION ANALYSIS
OF
TAXPAYER PROTECTION, CAPITAL MARKETS REFORM AND INTERNATIONAL COMPETITIVENESS ACT

(draft of December 10, 1990)

TITLE I -- SECURITIES AND SECURITIES-RELATED ACTIVITIES OF FEDERALLY-INSURED BANKS AND BANK HOLDING COMPANIES.

SEC. 101. AMENDMENT TO THE BANKING ACT OF 1933.

This section amends Section 20 of the Glass-Steagall Act, which restricts affiliations between member banks and securities firms. The amendment eliminates the "engaged principally" loophole used by the Federal Reserve Board to authorize underwriting of bank-ineligible securities by bank holding companies through so-called Section 20 affiliates. The amendment also eliminates the non-member bank loophole and makes the provisions of Section 20 applicable to any "bank" as defined under the Bank Holding Company Act of 1956. The amendment does not grandfather existing Section 20 affiliates, but gives them one year from the date of enactment to conform to the bill's requirements for securities subsidiaries of bank holding companies. During that year, such Section 20 affiliates may engage only in activities approved by the Federal Reserve Board prior to the date of enactment of the Act, subject to the "firewall" provisions of the Board's January 18, 1989 Section 20 order. The amendment specifies that the scope of "engaged principally" approvals for bank-ineligible securities may not be increased beyond the currently authorized 10% of total revenues test.

This section also authorizes affiliations between banks and qualified securities subsidiaries of the bank holding company authorized by Section 102 of the Act. The effect of this section is to require all underwriting and dealing activities of bank affiliates to be conducted through qualified securities subsidiaries.

SEC. 102. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ESTABLISH SECURITIES SUBSIDIARIES.

Section 102(a) amends the Bank Holding Company Act to authorize the formation by bank holding companies of qualified securities subsidiaries. A bank holding company may form more than one qualified securities subsidiary, provided each complies with the applicable requirements.

Section 102(b) amends the Bank Holding Company Act to insert a definition of securities subsidiary and qualified securities subsidiary. A "qualified securities subsidiary" is defined as any company:

- which is a direct subsidiary of a bank holding company, of an investment banking financing company controlled by a bank holding company, or of another qualified securities subsidiary;
- which is not an insured depository institution or a subsidiary or parent of an insured depository institution; and
- the formation or acquisition of which has been approved by the Federal Reserve Board.

This section also defines "securities subsidiary" to mean any qualified securities subsidiary and any subsidiary of a qualified securities subsidiary.

Section 102(c) amends the Bank Holding Company Act to specify the authorized activities of a qualified securities subsidiary. Such subsidiaries are authorized to:

- engage in underwriting, distributing, or dealing in securities;
- engage in securities brokerage, private placement, investment advisory, financial advisory, or other securities activities that are permitted under the Taxpayer Protection, Capital Markets Reform,

and International Competitiveness Act of 1991 or other applicable law for brokers or dealers registered under the Securities Exchange Act of 1934 or for investment advisers registered under the Investment Advisers Act of 1940;

- engage in organizing, sponsoring, managing, or controlling an investment company or in underwriting, distribution, or public or private sale of securities issued by an investment company;
- engage in foreign exchange operations and interest rate and currency swaps;
- engage in transactions involving commodities, futures contracts, and options contracts;
- acquire the shares of another qualified securities subsidiary; and
- engage in, or acquire the shares of any company engaged in, any activity which is not described above if such activity is otherwise authorized under the Bank Holding Company Act.

Section 102(c) also amends the Bank Holding Company Act to specify the conditions to formation of a qualified securities subsidiary. The section requires that the Federal Reserve Board approve such formation, and prohibits such approval under the circumstances described below.

Approval of a qualified securities subsidiary is prohibited if the Federal Reserve Board determines that any insured depository institution which is a subsidiary of such bank holding company fails, at the time of the application, to meet the risk-based capital guidelines established by the Board with respect to both Tier 1 and Tier 2 capital as such guidelines apply after 1992.

Section 102(c) also amends the Bank Holding Company Act to require a bank holding company to transfer to its qualified securities subsidiaries, with certain exceptions, all securities and securities-related activities conducted by the holding company's other subsidiaries. It provides that, except in the case of securities and securities-related activities expressly authorized to be conducted outside a securities subsidiary, no subsidiary of a bank holding company (other than a qualified securities subsidiary or investment banking financing company) may:

- engage in underwriting, distributing, or dealing in securities;
- engage in securities brokerage, private placement, investment advisory, financial advisory, or other securities activities that are permitted for brokers or dealers registered under the Securities Exchange Act of 1934 or for investment advisers registered under the Investment Advisers Act of 1940;
- engage in any activities with respect to an investment company that may be conducted by the qualified securities subsidiary;
- engage in foreign exchange operations and interest rate and currency swaps; or
- engage in transactions involving commodities, futures contracts, and options.

Existing Section 20 subsidiaries are given a one-year transition period to convert into a qualified securities subsidiary or otherwise comply with the transfer requirements, and in hardship situations the Federal Reserve Board is authorized to extend the transfer period to a date no later than one year after the qualified securities subsidiary commences operations. In addition, with respect to the following activities, the transfer requirement is inapplicable to any bank, thrift institution, or company controlled by a bank holding company:

- buying or selling, as principal or agent, or underwriting U.S. Treasury securities;
- buying or selling securities (A) issued by such bank, thrift, or company, or (B) eligible investment securities purchased for its own account;
- buying or selling any security, or providing investment advisory or financial advisory services as trustee, executor, administrator, custodian, managing agent, or guardian of estates with respect to the account of a customer; or
- engaging in foreign exchange operations, interest rate swaps, or currency swaps (A) for the account of a customer in connection with commercial lending or trade transactions, or (B) for its own account, but solely to the extent required for its own interest rate or currency risk management.

Section 102(c) also amends the Bank Holding Company Act to require a bank holding company that forms a qualified securities subsidiary to cease the conduct of any securities activities other those authorized for national banks if the bank holding company fails to meet the Federal Reserve Board's Capital Adequacy Guidelines.

SEC. 103. BANK SECURITIES AND INVESTMENT ACTIVITIES.

Section 103(a) reorganizes Section 16 of the Glass-Steagall Act to make it more readable, and makes the following clarifications regarding the authorized securities activities of national banks:

Subsection (a)(7) of the revised Section 16 of the Glass-Steagall Act expressly states that asset-backed securities backed by a bank's assets are included within Section 16's prohibitions and that the underwriting of securities is not included within the "incidental powers" of national banks under Section 16. This amendment is necessary to eliminate the effect of a recent federal appellate court interpretation of Section 16 that would make Section 16 a nullity.

Subsection (b)(1) of the revised Section 16 of the Glass-Steagall Act clarifies that asset-backed securities, including securities evidencing interests in a pool of assets of a bank, are included in the proscription on securities underwriting by banks. This amendment likewise is prompted by the above-referenced court decision.

Subsections (b)(7) and (b)(8) of the revised Section 16 of the Glass-Steagall Act define the terms "security" and "asset-backed security," respectively. The term "security" as used in Section 16 is defined as having the same meaning as it does under the Securities Act of 1933, with the exception that it does not include securities issued by a bank in the course of specified banking activities.

Subsection (c)(10) codifies existing law on the ownership and permissible activities of operations subsidiaries of national banks.

Section 103(b) amends the Federal Deposit Insurance Act to make the affiliation restrictions of Section 20 of the Glass-Steagall Act (as amended by Section 101 of the Act) applicable to all federally insured banks. The effect of the amendment is to require all underwriting and dealing activities of affiliates of federally insured banks to be conducted through qualified securities subsidiaries, with the exception that banking organizations which choose not to carry on new securities activities authorized under Section 102 of the Act may continue for up to two years after the date of enactment to operate Section 20 affiliates within the "engaged principally" parameters. A transition period is provided, ending on the earlier of two years after the date of enactment of the Act or the date on which the insured bank becomes affiliated with a qualified securities subsidiary.

The amendment preserves an exception to the affiliation restrictions for any affiliation which commenced before March 5, 1987, and also creates an exception for affiliations involving federally insured banks that fall outside the Bank Holding Company Act's definition of "bank."

Section 103(c) contains technical and conforming amendments necessitated by the reorganization of Section 16 of the Glass-Steagall Act effectuated under Section 103(a) of the Act.

SEC. 104. TRANSFER OF FOREIGN SECURITIES AND SECURITIES RELATED ACTIVITIES OF UNITED STATES BANKING ORGANIZATIONS TO QUALIFIED SECURITIES SUBSIDIARY.

This section amends the Federal Reserve Act and the Bank Holding Company Act to require that foreign securities and securities-related activities of U.S. banking organizations (other than Edge corporations and Agreement corporations, which are not permitted to take deposits) be conducted subject to the transfer requirements imposed under Section 102(c) of the Act. Thus, a bank holding company would be required to

conduct its foreign, as well as domestic, securities and securities-related activities through the qualified securities subsidiary, with the exceptions described in Section 102(c) of the Act.

SEC. 105. BANK HOLDING COMPANY FORMATION THROUGH REORGANIZATIONS.

This section amends the Bank Holding Company Act's requirement of prior approval by the Federal Reserve Board of the formation of a bank holding company to provide for an expedited 30 day notice procedure when shareholders are merely restructuring their existing ownership interests. This new procedure applies to the formation of bank holding companies when: (1) the prospective bank holding company is the result of a reorganization in which bank shareholders maintain substantially the same proportionate interest in the holding company as they held in the bank; (2) the new bank holding company does not engage in any activity other than banking or managing and controlling banks; and (3) the bank holding company meets the capital and other financial standards prescribed by regulation of the Federal Reserve Board for a bank holding company.

TITLE II--INVESTMENT BANKING FINANCING COMPANIES AND RETAIL INSURED BANKS.

Subtitle A - Creation of Investment Banking Financing Companies

SEC. 201. SHORT TITLE.

This section specifies that this subtitle of the Act shall be cited as the "Investment Banking Financing Company Act of 1991."

SEC. 202. INVESTMENT BANKING FINANCING COMPANIES

Section 202(a) provides that any bank holding company, broker or dealer, or affiliate of a broker or dealer may apply to the Comptroller of the Currency for permission to organize an investment banking financing company. In the case of an investment banking financing company to be controlled by a bank holding company, the requirements of Section 7 of the Bank Holding Company Act of 1956 (as inserted by Section 211(d) of this Act) shall also apply. Upon approval of the application, such investment banking financing company shall be a body corporate, chartered under the laws of the United States by the Comptroller.

Section 202(b) prohibits any person from organizing an investment banking financing company, and any investment banking financing company from transacting any business prior to completion of its organization, except as provided in the Act and in implementing regulations of the Comptroller.

Section 202(c) sets forth the authorized activities of investment banking financing companies. Except as otherwise provided in the Act, an investment banking financing company may exercise, in accordance with its articles of organization and such regulations as are issued by the Comptroller, all of the powers and privileges of a national banking association. In addition, an investment banking financing company may acquire, directly or indirectly, the shares of one or more qualified securities subsidiaries.

Section 202(d) sets forth certain limitations on the activities of investment banking financing companies. No investment banking financing company may:

- become an insured depository institution or an insured credit union, or acquire (directly or indirectly) control of such an insured depository institution or insured credit union; or
- permit any customer to open a deposit account with less than $100,000.

Section 202(e) provides that the capital of an investment banking financing company shall be maintained at all times at such level and in such a manner as the Comptroller may prescribe by regulation.

Section 202(f) sets forth the definition of a qualified securities subsidiary. A qualified securities subsidiary is any company which is wholly owned by an investment banking financing company or by a wholly-owned subsidiary thereof (including another qualified securities subsidiary) and is any one or more of the following:

- a broker or dealer registered under the Securities Exchange Act of 1934, as amended, or the Commodities Exchange Act of 1936, as amended;
- an investment company registered under the Investment Company Act of 1940, as amended; or
- an investment adviser registered under the Investment Advisers Act of 1940, as amended.

Subsection 202(g) authorizes the Comptroller to promulgate such regulations as are necessary to implement the provisions of this section.

SEC. 203. REGULATION AND SUPERVISION OF INVESTMENT BANKING FINANCING COMPANIES AND QUALIFIED SECURITIES SUBSIDIARIES.

Section 203(a) states the intent of Congress that individual financial services businesses within a diversified holding company or conglomerate-type corporate complex should be functionally regulated and that overlapping regulation and supervision of the same activity, which leads to conflicts of jurisdiction, should be avoided. Section 203(a) also provides for interpretation of this section in a manner consistent with such congressional purpose.

Section 203(b) provides for the regulation and supervision of investment banking financing companies. The authority to regulate and supervise the activities of investment banking financing companies is vested exclusively in the Comptroller of the Currency. It is specified, however, that the Comptroller shall have no authority to regulate or supervise the activities of any qualified securities subsidiary of an investment banking financing company or of any broker, dealer, affiliate of a broker or dealer, or bank holding company which controls an investment banking financing company.

Each investment banking financing company and each subsidiary thereof (other than a qualified securities subsidiary) shall be subject to such examinations and to such reporting and recordkeeping requirements as the Comptroller may prescribe.

If any investment banking financing company fails to maintain capital at or above the minimum level prescribed by the Comptroller's regulations, the Comptroller may issue a directive requiring the investment banking financing company to submit and adhere to a plan for increasing capital which is acceptable to the Comptroller. If an investment banking financing company subject to a capital directive fails to submit or adhere to a plan for increasing capital which is acceptable to the Comptroller, or if the Comptroller has reasonable cause to believe that any investment banking financing company has permitted any customer to open a deposit account with less than $100,000, has taken any action which has caused it to become an insured depository institution or an insured credit union, or has represented to any person that any deposit accepted by such investment banking financing company is an insured deposit within the meaning of section 3(m) of the Federal Deposit Insurance Act of 1950, as amended, the Comptroller, upon satisfaction of certain conditions, may issue an order to cease and desist from any such violation or violations and take affirmative action to correct the conditions resulting from any such violation or violations. Any person who violates, or who causes an investment banking financing company to violate any final cease-and-desist order, shall be subject to a civil penalty of not more than $100,000 for each day during which such violation continues.

If the Comptroller determines that any investment banking financing company has violated any final cease-and-desist order, the Comptroller may, in addition to or in lieu of any other remedies provided by law, issue an order revoking the charter of such investment banking financing company. The investment banking financing company may seek judicial review of such an order.

Subsection 203(c) provides that the authority to regulate and supervise the activities of a qualified securities subsidiary shall be vested in the Securities and Exchange Commission, with respect to activities as to which such qualified securities subsidiary is registered (or is required to register) under the Securities Exchange Act of 1934, as amended, the Investment Company Act of 1940, as amended, or the Investment Advisers Act of 1940, as amended, and the Commodities Futures Trading Commission, with respect to any activities as to which such qualified securities subsidiary is registered (or is required to register) under the Commodities Exchange Act of 1936, as amended.

SEC. 204. EFFECT ON CERTAIN STATE LAWS.

This section expressly preempts any state statute, regulation, or other official action which would prohibit, prevent, or impede the affiliation of insured depository institutions, brokers, dealers, and investment banking financing companies or would discriminate against, or impose differential treatment upon, any such entity solely by reason of any such affiliation.

Subtitle B - Investment Banking Financing Company Subsidiaries of Bank Holding Companies

SEC. 211. INVESTMENT BANKING FINANCING COMPANY SUBSIDIARIES OF BANK HOLDING COMPANIES AUTHORIZED.

Section 211(a) amends section 4 of the Bank Holding Company Act to authorize the formation by bank holding companies of investment banking financing companies.

Section 211(b) amends the Bank Holding Company Act to insert a definition of investment banking financing company. An "investment banking financing company" is defined as any company which:

- is not a subsidiary or parent of a federally insured depository institution; and
- is chartered by the Comptroller of the Currency pursuant to Subtitle A, above, and engages in the activities and is subject to the limitations prescribed thereunder.

The formation or acquisition of the investment banking financing company must be approved by the Federal Reserve Board.

Section 211(c) amends the Bank Holding Company Act to exclude an investment banking financing company from the definition of "bank" under the Bank Holding Company Act. The amendment also clarifies the ability of securities firms to establish investment banking financing companies without becoming bank holding companies.

Section 211(d) amends the Bank Holding Company Act to specify the conditions for formation of an investment banking financing company by a bank holding company. The section requires prior Federal Reserve Board approval and prohibits such approval where the Board determines (i) that the applicant bank holding company has failed to provide such information as is required by regulations promulgated by the Board; or (ii) that any insured depository institution controlled by such bank holding company fails at the time of application, or upon consummation of the transaction will fail, to meet the risk-based capital guidelines established by the appropriate Federal banking agency with respect to both Tier 1 and Tier 2 capital as such guidelines apply after 1992.

SEC. 212. RESERVE REQUIREMENTS FOR INVESTMENT BANKING FINANCING COMPANIES.

Section 212(a) amends the Federal Reserve Act's definition of "depository institution" to include within it investment banking financing companies. The effect of this amendment is to allow IBFCs to obtain access to certain Federal Reserve System services.

Section 212(b) makes clear that an investment banking financing company shall not be required to maintain reserves against deposits notwithstanding its qualifying as a "depository institution" within the meaning of the Federal Reserve Act.

Section 212(c) amends the Federal Reserve Act to provide that, unlike other depository institutions, which are automatically granted the same discount and borrowing privileges that member banks have, investment banking financing companies shall have only such discount and borrowing privileges as are expressly granted by statute to such investment banking financing companies.

Subtitle C - Retail Insured Banks

SEC. 221. SHORT TITLE.

This section specifies that this subtitle shall be cited as the "Retail Insured Bank Act of 1991."

SEC. 222. AUTHORIZATION FOR CERTAIN ORGANIZATIONS TO ESTABLISH RETAIL INSURED BANKS.

Section 222(a) amends the Bank Holding Company Act to permit certain non-banking companies to establish federally insured retail banks without becoming bank holding companies. This authorization is granted through an exception to the Bank Holding Company Act's definition of "bank" for a retail insured bank. A retail insured bank is defined as a company which:

- is an insured bank for purposes of the Federal Deposit Insurance Act;
- is an affiliate of a broker or of a dealer; and
- engages solely in the business of accepting deposits and providing traditional banking services (such as loans, discounts, and trust services) for personal, family or household purposes (including margin lending) and does not engage in the business of making commercial loans.

Section 222(b) subjects a retail insured bank to the anti-tying provisions of section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. §§ 1971-1972) and the limitations on loans to insiders contained in Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O. Thus, in the case of a retail insured bank which is not owned or controlled by a bank holding company but is owned or controlled by a broker or dealer, the provisions of section 106 will be applicable to such broker or dealer, with respect to such retail insured bank, as if such broker or dealer were a bank holding company.

TITLE III – BANK, CONSUMER AND MARKET INTEGRITY SAFEGUARD PROVISIONS.

SEC. 301. BANK SAFETY AND SOUNDNESS.

This section amends the Bank Holding Company Act to insert the following statutory "firewall" provisions applicable to bank holding companies that control qualified securities subsidiaries or investment banking financing companies:

Credit Transactions

No bank or insured institution controlled by such bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

- Except as permitted with respect to intra-day clearance transactions, extend credit in any manner to the investment banking financing company or securities subsidiary.

- Purchase for the bank's or insured institution's own account, or the account of any subsidiary of the bank or insured institution, any financial asset of the investment banking financing company or securities subsidiary.
- Purchase for the bank's or insured institution's own account, or for the account of any subsidiary of the bank or the insured institution, any security of which the securities subsidiary is an underwriter or a member of the selling group during the underwriting period and for 90 days after the effective date of the relevant registration statement, if any, whichever is later.
- Issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, to or for the benefit of the investment banking financing company or securities subsidiary.
- Extend credit in any manner to any investment company which is sponsored, organized, controlled, managed or advised by the securities subsidiary.

A bank or insured institution controlled by a bank holding company, or a subsidiary of any such bank or insured institution, may extend credit to an affiliated qualified securities subsidiary or investment banking financing company in connection with the purchase or sale of any United States obligations if the credit is to be repaid on the same calendar day, is incidental to the clearing of transactions in those securities through such bank, insured institution, or subsidiary, and the principal of and the interest on the extension of credit are fully secured by United States obligations.

No bank or insured institution controlled by a bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

- Extending credit to an issuer of securities of which the securities subsidiary is an underwriter for the purpose of paying, in whole or in part, the principal of, or any interest or dividends on, those securities.
- Extending credit to a customer of the investment banking financing company or qualified securities subsidiary for the purpose of repaying, in whole or in part, credit extended to such customer by the investment banking financing company or securities subsidiary.

Tying Transactions

No bank or insured institution controlled by a bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

- Extending credit, arranging for the extension of credit, or issuing or entering into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility in connection with any transaction in which the investment banking financing company or securities subsidiary provides services.
- Extending credit, arranging for the extension of credit, or issuing or entering into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of any person that has obtained services from the investment banking financing company or securities subsidiary within the preceding 6 months.

No investment banking financing company or securities subsidiary may engage in any of the following transactions with respect to any affiliated bank or insured institution, or any subsidiary thereof:

- Providing services in connection with any transaction in which the affiliated bank or insured institution directly or indirectly extends credit, arranges for the extension of credit, or issues or enters into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility.
- Providing services to or for the benefit of any person to which the affiliated bank or insured institution has directly or indirectly extended credit, arranged for the extension of credit, or issued or

entered into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility within the preceding 6 months.

An exception to the above-described prohibitions is provided for any credit or credit instrument or facility provided by a bank or insured institution, or services provided by an investment banking financing company or securities subsidiary, in connection with a transaction consisting exclusively of the securitization of assets comprised of residential mortgage loans or consumer receivables originated by such bank or insured institution or an affiliate thereof.

An exception also is provided for any credit or credit facility or instrument provided by a bank or insured institution prior to the date on which the bank holding company establishes a qualified securities subsidiary.

Prohibitions During Distribution Period

No bank holding company and no bank, insured institution, or company (other than an investment banking financing company or securities subsidiary) controlled by a bank holding company may, directly or indirectly, extend credit or arrange for the extension of credit to any person if such credit is secured by, or is used for the purpose of purchasing, any security during the period, and for 30 days after the end of the period, in which such security is the subject of a distribution in which a securities subsidiary of such bank holding company participates as an underwriter or member of the selling group.

Confidential Information

No bank or insured institution controlled by a bank holding company which controls an investment banking financing company or a qualified securities subsidiary may disclose, directly or indirectly, any confidential customer information to any investment banking financing company or securities subsidiary controlled by such bank holding company.

For purposes of this prohibition, "confidential customer information" means financial information, including any evaluation of creditworthiness, concerning or acquired from a customer of a bank or insured institution, or any subsidiary thereof, by reason of a business relationship with the customer of a type which would not, in the ordinary course of business, be divulged to a company of which such bank, insured institution, or subsidiary is not an affiliate, or information obtained through access to the payment system. However, the term "confidential customer information" does not include any information available from an unaffiliated credit bureau or similar commercially available source.

Reciprocal Arrangements

No bank holding company and no bank, insured institution, or company controlled by a bank holding company may enter into any reciprocal arrangement. The term "reciprocal arrangement" is defined as any agreement, understanding, or other arrangement under which one bank holding company (or any entity controlled by such bank holding company) agrees to engage in a transaction with, or on behalf of, another bank holding company (or any entity controlled by such other holding company), in exchange for the agreement of the second bank holding company (or any entity controlled by such company) to engage in a transaction with, or on behalf of, the first bank holding company (or any entity controlled by such company) for the purpose of evading any requirement or prohibition on transactions between, or for the benefit of, affiliates of bank holding companies established under or pursuant to any Federal banking law or regulation.

Director or Management Official Interlocks

No bank holding company may allow any director or management official of any investment banking financing company or securities subsidiary controlled by such bank holding company to serve at the same time

as a director or management official of any affiliated bank or insured institution (or any subsidiary thereof). For purposes of this prohibition, the term "management official" includes any officer and any employee with management functions (including a branch manager), any trustee of a business organization under the control of trustees (such as a mutual savings bank), and any person who has a representative or nominee serving in any of those capacities.

There is a small bank holding company exception to this prohibition, which permits a director or management official of any investment banking financing company or securities subsidiary controlled by a bank holding company to serve at the same time as a director or management official of an affiliated bank or insured institution (or any subsidiary thereof) if the total banking assets of the bank holding company do not exceed $500,000,000 (adjusted annually for inflation).

Applicability of Credit Firewalls to Non-Bank Affiliates

The firewall provisions described under "Credit Transactions" and "Tying Transactions" are made applicable to any bank holding company that controls an investment banking financing company or qualified securities subsidiary, or any subsidiary of such bank holding company, during any period in which such bank holding company or subsidiary, as the case may be, is an "insured depository institution beneficiary."

For purposes of application of such firewalls, a bank holding company or subsidiary thereof is an "insured depository institution beneficiary" if--

- A bank or insured institution controlled by the bank holding company has outstanding credit or an outstanding guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of such bank holding company or subsidiary, as the case may be; or
- An insured depository institution beneficiary (as described in the preceding paragraph) controlled by the bank holding company has outstanding credit or an outstanding guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of such bank holding company or subsidiary, as the case may be.

A bank holding company or subsidiary thereof is not considered an insured depository institution beneficiary if the outstanding credit or credit facility involved is in an amount not in excess of $1,000,000 (adjusted annually for inflation).

Discriminatory Credit Treatment

No bank or insured institution controlled by a bank holding company that also controls a qualified securities subsidiary may:

- Extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated broker or dealer less favorably than such qualified securities subsidiary, unless the extension of credit or denial is based on objective criteria and is consistent with sound business practices; or
- Extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for such qualified securities subsidiary.

Certain Transactions Prohibited

No bank holding company may extend credit to, transfer financial assets to, or make an equity investment in any investment banking financing company or securities subsidiary without prior notice to the Federal Reserve Board. The Board may prohibit any transaction described in the preceding sentence if it

28

determines that such transaction would affect the financial resources of the bank holding company to such an extent that it would likely impair or diminish significantly the bank holding company's ability to provide financial resources to any bank or insured institution controlled by such bank holding company for any federally insured depository institution subsidiary of the bank holding company.

Additional Restrictions by Federal Reserve Board

The Federal Reserve Board may, to preserve the safety and soundness of banks and insured institutions controlled by bank holding companies and to ensure that the activities of investment banking financing companies and qualified securities subsidiaries controlled by bank holding companies are conducted without the support of affiliated insured depository institutions, promulgate regulations setting forth additional limitations on transactions or other contacts between or among any bank or insured institution controlled by a bank holding company and any affiliated investment banking financing companies or qualified securities subsidiaries.

SEC. 302. CONSUMER DISCLOSURE REQUIREMENTS.

This section amends the Bank Holding Company Act to require any bank holding company which controls a securities subsidiary to cause that subsidiary to disclose prominently in writing to each of its customers, and in any advertising of the products and services it offers, that:

- the securities subsidiary is not a federally insured bank or insured institution, and is a separate corporate entity with respect to any bank or insured institution affiliate of such subsidiary; and
- securities underwritten, sold, offered, or recommended by the securities subsidiary are not deposit instruments which are federally insured, are not instruments which are guaranteed either as to principal or interest by a bank or insured institution affiliate of such subsidiary, and are not otherwise obligations of any bank or insured institution.

This section also amends the Bank Holding Company Act to provide that no bank or insured institution controlled by a bank holding company (and no subsidiary thereof) shall provide to any customer or in connection with any advertisement an opinion on the value of, or the advisability of purchasing or selling, securities of which an affiliated securities subsidiary is an underwriter or which such affiliated securities subsidiary sells or offers for sale, unless such bank, insured institution, or subsidiary prominently discloses to the customer in writing, or prominently discloses in the advertisement, as the case may be, and in accordance with such requirements as the Federal Reserve Board may promulgate, that:

- the securities subsidiary is an affiliate of such bank, insured institution, or subsidiary;
- the securities subsidiary is not a bank or insured institution, and is a separate corporate entity with respect to any bank or insured institution (or any subsidiary of such bank or insured institution) which is an affiliate of such securities subsidiary; and
- the securities underwritten, sold, offered, or recommended by the securities subsidiary are not deposit instruments which are federally insured, are not instruments which are guaranteed either as to principal or interest by a bank or insured institution affiliate of such subsidiary, and are not otherwise obligations of any bank or insured institution.

SEC. 303. ADMINISTRATIVE ENFORCEMENT AND PENALTIES FOR VIOLATIONS.

This section amends the Bank Holding Company Act to provide augmented civil and administrative penalties for violations of the "firewall" provisions applicable to bank holding companies under this Act.

Section 303(a) provides civil penalties of (i) for corporated entities, up to $100,000 for any violation of the firewall provisions, with an additional maximum penalty of $10,000 per day of a continuing violation; and (ii)

for natural persons, up to $50,000 for any violation of the firewall provisions and an additional maximum penalty of $5,000 per day of a continuing violation.

Section 303(b) authorizes the Federal Reserve Board to require a bank holding company that willfully or continuously violates the firewall provisions to divest itself of its federally insured bank or thrift subsidiaries. The section also specifies the administrative procedures to be followed if the bank holding company wishes to contest such a determination by the Board.

SEC. 304. APPLICATION OF FEDERAL DEPOSIT INSURANCE COVERAGE.

This section cuts back the "too big to fail" doctrine by amending the Federal Deposit Insurance Act to prohibit the FDIC from using its funds to bail out non-insured affiliates of federally insured banks or thrifts.

SEC. 305. REGULATIONS.

This section requires the Federal Reserve Board to submit to Congress proposed regulations implementing the amendments to the Bank Holding Company Act made by this Title III within 90 days of enactment, and to publish final regulations within 150 days of enactment.

TITLE IV – SECURITIES REGULATION OF SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS.

Subtitle A - Broker-Dealer Provisions

SEC. 401. DEFINITION OF BROKER.

This section amends the definition of "broker" in the Securities Exchange Act of 1934 to eliminate, with certain exceptions, the bank exemption from such definition. Under the amended definition, a bank will be treated as a broker under the 1934 Act if it is engaged in the business of effecting transactions in securities for the account of others. However, a bank shall not be deemed a broker solely because it engages in one or more of the following activities:

- trust activities (including effecting transactions in the course of such trust activities) unless the bank publicly solicits brokerage business other than by advertising, in conjunction with advertising its other trust activities, that it effects transactions in securities, or unless, with certain exceptions, the bank is compensated for such business by the payment of commissions or similar remuneration based on effecting transactions in securities (excluding fees calculated as a percentage of assets under management) in excess of the bank's incremental costs directly attributable to effecting such transactions;
- transactions in exempted securities other than municipal securities or in commercial paper, bankers' acceptances, or commercial bills; or
- transactions in municipal securities if the bank is not affiliated with a qualified securities subsidiary.

SEC. 402. DEFINITION OF DEALER.

This section amends the definition of "dealer" in the Securities Exchange Act of 1934 to eliminate, with certain exceptions, the bank exemption from such definition. Under the amended definition, a bank will be treated as a dealer under the 1934 Act if it is engaged in the business of buying and selling securities for its own account. However, a bank shall not be deemed a dealer solely because it engages in one or more of the following activities:

- buys and sells securities other than as part of a regular business;
- buys and sells commercial paper, bankers' acceptances, commercial bills or exempted securities other than municipal securities;
- buys and sells municipal securities if the bank is not affiliated with a qualified securities subsidiary; or
- buys and sells securities for investment purposes in the course of trust activities.

SEC. 403. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER.

This section amends the Securities Exchange Act of 1934 to authorize the SEC to exempt any person or class of persons from the definitions of "broker" or "dealer" under the 1934 Act if the SEC finds that such exemption is consistent with the public interest and the protection of investors.

SEC. 404. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY.

This section amends the Securities Exchange Act of 1934 to make it unlawful for any bank to act as a broker or dealer. The amendment permits activities of a broker or dealer to be conducted through a bank subsidiary or other bank affiliate, provided such subsidiary or affiliate is registered as a broker or dealer pursuant to the 1934 Act. The SEC is authorized to exempt from this prohibition any person or class of persons if the SEC finds that such exemption is consistent with the public interest and the protection of investors.

Subtitle B - Emergency Credit During Generalized Liquidity Crisis

SEC. 411. EMERGENCY ACCESS TO FEDERAL RESERVE BY CERTAIN INSTITUTIONS.

This section amends the Federal Reserve Act's existing provision authorizing the Federal Reserve Board to make loans collateralized by United States obligations to any individual, partnership or corporation for periods not exceeding 90 days. The amendment is intended to regularize the procedures for such Federal Reserve access by broker-dealers in times of generalized liquidity crisis.

The amended language specifies that the Federal Reserve Board may make credit available to brokers and dealers upon request on any day on which it receives notice from the SEC stating that on such date there is a generalized liquidity crisis affecting brokers and dealers. A broker or dealer seeking such credit must (i) certify to the Federal Reserve Board that the amount of the requested credit does not exceed the amount needed by such broker or dealer on such date as a result of a generalized liquidity crisis and (ii) attach to such certification written confirmation from the SEC that (A) as of the latest date for which such information is available, the broker or dealer was in compliance with the SEC's capital requirements and (B) the SEC has no reason to believe that, as of the date of such request, the broker or dealer is not in compliance with the SEC's capital requirements. The SEC is required to provide to the Federal Reserve Board in a timely fashion any reports in its possession concerning compliance by a broker or dealer with the SEC's capital requirements as the Federal Reserve Board may specify in connection with a request by a broker or dealer for an emergency liquidity loan. If the Federal Reserve Board subsequently determines that the certification made by a broker or dealer to obtain an emergency liquidity loan was made in bad faith, the certifying broker or dealer shall be barred from access to the Federal Reserve for a period of three years.

The amended language provides identical emergency access to the Federal Reserve for investment banking financing companies.

TITLE V – NATIONAL ELECTRONIC PAYMENTS CORPORATION.

This title implements a proposal made by E. Gerald Corrigan, president of the Federal Reserve Bank of New York, to restructure and privatize the large dollar electronic payments system so as to minimize the risks of system failure and give large non-bank users of the system, as well as banks, direct access to the system and partial control over its operation."

SEC. 501. SHORT TITLE.

This section specifies that the name of this Title shall be the "National Electronic Payments Corporation Act of 1991."

SEC. 502. PURPOSE.

This section sets forth the purposes of this Title:

- to muster the equity investment needed to upgrade materially and streamline the crucial operational systems and backup systems needed to enhance the reliability and integrity of the large-dollar electronic payments system;
- to achieve a major step forward in providing finality of payments;
- to augment the cash and liquidity balances associated with the operation of the system;
- to provide a vehicle through which public and private institutions can work together in securing a safer and more efficient payments mechanism;
- to provide equal access to the system to all large users thereof; and
- to establish a vehicle which can materially reduce the susceptibility of the payments systems to shocks whether they are operational, liquidity-related, or credit-related in nature.

SEC. 503. DEFINITIONS.

This section defines certain terms used in this Title.

SEC. 504. ESTABLISHMENT OF THE CORPORATION.

This section establishes a National Electronic Payments Corporation as a body corporate. The Corporation's directors consist of 4 members selected by the Federal Reserve Board and 3 members selected by the Corporation's private shareholders.

SEC. 505. DUTIES OF THE CORPORATION.

Section 505(a) provides that the National Electronics Payment Corporation shall have the following duties:

- to establish, operate, and maintain a national electronic payments system to facilitate large dollar transactions, such as funds transfers and transfers of book entry United States Government securities, drawn on accounts at Federal Reserve banks;
- to promulgate and enforce policies governing standards for utilization of the national electronic payments system, including requirements for the maintenance of liquidity reserve balances in Federal Reserve banks, including a stock subscription requirement;
- to provide for the development or improvement of telecommunications facilities to operate the national electronic payments system, with appropriate levels of backup and bypass facilities to assure operational reliability of the system;
- to prescribe procedures relating to the operation of the system, including procedures to enforce compliance with orders of the Federal Reserve Board relating to intraday overdrafts; and

• to take such other actions as may be necessary to carry out the purposes of this Title.

Section 505(b) provides that all payments made through the national electronic payments system shall be final and irrevocable upon receipt.

SEC. 506. CAPITALIZATION.

Section 506(a) provides that the authorized equity capital of the National Electronic Payments Corporation shall be $900 million, of which not less than $450 million and not more than $500 million shall be paid in by the Federal Reserve System, and the balance shall be paid in by private shareholders.

Section 506(b) authorizes the National Electronic Payments Corporation to pay dividends to its shareholders from time to time at a dividend rate that takes into account the need to retain sufficient earnings to assure continuing research and development on payment system technology and the establishment and maintenance of an adequate level of capital.

SEC. 507. ACCESS TO THE SYSTEM.

Section 507(a) requires establishment by the National Electronic Payments Corporation of a list of banking and other financial organizations which have transactions in funds and government securities of a sufficient magnitude to make their participation as shareholders in the Corporation appropriate. It is provided that the Corporation shall not discriminate among organizations on the basis of whether or not such organizations are banking organizations or not. After establishing such list, the Corporation is directed to invite the participation of those organizations as shareholders in the Corporation. The Corporation is authorized, in its discretion, to limit direct access to the payment system to only those organizations which are shareholders in the Corporation.

Section 507(b) directs the National Electronic Payments Corporation to establish fees for use of the payment system.

SEC. 508. REPORTS TO CONGRESS.

This section requires the National Electronic Payments Corporation to submit annual reports to Congress concerning its activities in the preceding fiscal year.

SEC. 509. AUTHORIZATION OF APPROPRIATIONS.

This section authorizes appropriation of sums necessary to finance the organizational costs of the National Electronic Payments Corporation.

SEC. 510. TRANSITIONAL ACCESS TO FEDWIRE SYSTEM FOR CERTAIN FINANCIAL INSTITUTIONS.

This section provides for transitional access by broker-dealers and bank holding company investment banking financing companies to the Fedwire system until the privatized electronic payment system established in this Title becomes operational.

Section 510(a) provides that, during the period beginning 180 days after the effective date of the Act and terminating on the date the national electronic payments system to be established pursuant to Section 605 of the Act is operational, qualified financial organizations shall be permitted direct access to Fedwire.

Section 510(b) provides that, within 180 days after the effective date of the Act, the Federal Reserve Board shall revise its regulations and promulgate such additional regulations as are necessary or appropriate (i)

to establish participation standards for operational and backup systems of qualified financial organizations, (ii) to provide for direct access by qualified financial organizations to the Fedwire system and (iii) to provide that all payments made through the Fedwire system shall be final and irrevocable upon receipt. It is specified that the participation standards established by the Board of Governors pursuant to clause (i) of the preceding sentence may not discriminate among qualified financial organizations and bank participants in the Fedwire system.

Section 510(c) defines the term "qualified financial organization" to mean any broker-dealer or bank holding company investment banking financing company that has been determined by the Federal Reserve Board to have operational and backup systems for participation in the Fedwire electronic payments system that meet the participation standards promulgated by the Federal Reserve Board pursuant to subsection 510(b).

DRAFT LEGISLATION
FOR DISCUSSION PURPOSES ONLY

December 10, 1990

TAXPAYER PROTECTION, CAPITAL MARKETS REFORM AND INTERNATIONAL COMPETITIVENESS ACT

SECTION 1. SHORT TITLE.

This Act may be cited as the "Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991."

SECTION 2. CONGRESSIONAL FINDINGS AND STATEMENT OF PURPOSE.

(a) The Congress finds that--

(1) the benefits of federal deposit insurance are intended to promote public confidence in the banking system and to protect primarily the smaller deposits of individuals, families, and households;

(2) public confidence in the banking system and in the federal deposit insurance funds has been eroded by the dramatic increase in the numbers of bank and savings institution failures in recent years;

(3) the increased incidence of such failures has placed undue stress on the integrity of the federal deposit insurance funds;

(4) the health of the federal deposit insurance funds will be strengthened by permitting securities firms to engage in certain limited categories of banking activities;

(5) domestic banking organizations need to diversify their activities and investments in order to become stronger and more competitive internationally;

(6) such diversification can only be permitted in a manner which protects U.S. taxpayers from potential liability arising from exposure of the federal deposit insurance funds to additional risk occasioned by the entry of U.S. banking organizations into new lines of business; and

(7) reform of the financial services industries must ensure the continued vitality, openness, and competitiveness of U.S. capital markets and must not endanger the future competitive prospects of those segments of the financial services sector which are currently strong.

(b) The purposes of this Act are (i) to promote the international competitiveness of the banking and securities industries; (ii) to strengthen the federal deposit insurance funds by (A) permitting banking organizations to diversify fully into securities activities, subject to certain structural limitations designed to protect the deposit insurance funds from the riskiness of such activities, and (B) permitting securities firms to own retail insured banks, which may accept insured deposits but may use such deposits only for the purpose of meeting the credit needs of those for whom the protection of federal deposit insurance is primarily intended, thereby adding an additional source of capital to the banking system and promoting public confidence therein; and (iii) to provide both banking and securities firms the option of funding their activities through non-federally-insured deposits.

SECTION 3. REDESIGNATION OF SECTIONS OF THE BANK HOLDING COMPANY ACT OF 1956.

The Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841 et seq.), is amended by redesignating sections 5, 7, 8, 9, 11, and 12 as sections 9, 11, 12, 13, 14, and 15, respectively.

SECTION 4. TABLE OF CONTENTS AND LEGISLATIVE TEXT.

TITLE I -- SECURITIES AND SECURITIES-RELATED ACTIVITIES OF FEDERALLY-INSURED BANKS AND BANK HOLDING COMPANIES

SEC. 101. AMENDMENT TO THE BANKING ACT OF 1933.
SEC. 102. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ESTABLISH SECURITIES SUBSIDIARIES
SEC. 103. BANK SECURITIES AND INVESTMENT ACTIVITIES.
SEC. 104. TRANSFER OF FOREIGN SECURITIES AND SECURITIES RELATED ACTIVITIES OF UNITED STATES BANKING ORGANIZATIONS TO QUALIFIED SECURITIES SUBSIDIARY
SEC. 105. BANK HOLDING COMPANY FORMATION THROUGH REORGANIZATIONS.

TITLE II -- INVESTMENT BANKING FINANCING COMPANIES AND RETAIL INSURED BANKS

Subtitle A - CREATION OF INVESTMENT BANKING FINANCING COMPANIES

SEC. 201. SHORT TITLE.
SEC. 202. INVESTMENT BANKING FINANCING COMPANIES.
SEC. 203. REGULATION AND SUPERVISION OF INVESTMENT BANKING FINANCING COMPANIES AND QUALIFIED SECURITIES SUBSIDIARIES.
SEC. 204. EFFECT ON CERTAIN STATE LAWS.

Subtitle B - INVESTMENT BANKING FINANCING COMPANY SUBSIDIARIES OF BANK HOLDING COMPANIES

SEC. 211. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ESTABLISH INVESTMENT BANKING FINANCING COMPANY SUBSIDIARIES
SEC. 212. RESERVE REQUIREMENTS FOR INVESTMENT BANKING FINANCING COMPANIES

Subtitle C - RETAIL INSURED BANKS

SEC. 221. SHORT TITLE
SEC. 222. AUTHORIZATION FOR CERTAIN ORGANIZATIONS TO ESTABLISH RETAIL INSURED BANKS

TITLE III -- BANK, CONSUMER AND MARKET INTEGRITY SAFEGUARD PROVISIONS

SEC. 301. BANK SAFETY AND SOUNDNESS
SEC. 302. CONSUMER DISCLOSURE REQUIREMENTS.
SEC. 303. ADMINISTRATIVE ENFORCEMENT AND PENALTIES FOR VIOLATIONS.
SEC. 304. APPLICATION OF FEDERAL DEPOSIT INSURANCE COVERAGE.
SEC. 305. REGULATIONS.

TITLE IV -- SECURITIES REGULATION OF SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

Subtitle A - BROKER-DEALER PROVISIONS

SEC. 401. DEFINITION OF BROKER.
SEC. 402. DEFINITION OF DEALER.
SEC. 403. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER.
SEC. 404. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY.

Subtitle B - EMERGENCY CREDIT DURING GENERALIZED LIQUIDITY CRISIS

SEC. 411. ACCESS TO FEDERAL RESERVE BY CERTAIN INSTITUTIONS

TITLE V -- NATIONAL ELECTRONIC PAYMENTS CORPORATION

SEC. 501. SHORT TITLE.
SEC. 502. PURPOSE.
SEC. 503. DEFINITIONS.
SEC. 504. ESTABLISHMENT OF THE CORPORATION.
SEC. 505. DUTIES OF THE CORPORATION.
SEC. 506. CAPITALIZATION.
SEC. 507. ACCESS TO THE SYSTEM.
SEC. 508. REPORTS TO CONGRESS.
SEC. 509. AUTHORIZATION OF APPROPRIATIONS.
SEC. 510. TRANSITIONAL ACCESS TO FEDWIRE SYSTEM FOR CERTAIN FINANCIAL ORGANIZATIONS.

TITLE I – SECURITIES AND SECURITIES-RELATED ACTIVITIES OF FEDERALLY-INSURED BANKS AND BANK HOLDING COMPANIES

SECTION 101. AMENDMENT TO THE BANKING ACT OF 1933.

Section 20 of the Banking Act of 1933, as amended (12 U.S.C. § 377), is amended--

(1) by deleting the word "principally" in the first paragraph of such section;
(2) by deleting the word "member" at each place it appears in such section; and
(3) by adding at the end thereof the following new paragraphs:

"Notwithstanding any other provision of this section, a bank may be an affiliate of a qualified securities subsidiary (as defined in section 2(n) of the Bank Holding Company Act of 1956, as amended).

"A company which is affiliated with a bank and is engaged in any activity referred to in the first paragraph of this section pursuant to a written authorization by the Board of Governors of the Federal Reserve System issued prior to the date of enactment of the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991 may continue to engage in such activity for a period of one year after such date of enactment notwithstanding that such company is not a qualified securities subsidiary; Provided, That the revenues of such company derived from all such activities shall not exceed 10 percent of the total revenues of such company, calculated as set forth in the order of the Board of Governors of the Federal Reserve System dated January 18, 1989; and

Provided Further, That such activities shall be subject to the restrictions described in the order of the Board of Governors of the Federal Reserve System dated January 18, 1989.

"For purposes of this section, the term "bank" shall have the same meaning as provided in Section 2(c) of the Bank Holding Company Act of 1956, as amended."

SECTION 102. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ESTABLISH SECURITIES SUBSIDIARIES.

(a) SECURITIES SUBSIDIARY OF BANK HOLDING COMPANY ALLOWED.-- Section 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1843(c)), is amended--

(1) by inserting after paragraph (14) the following new paragraph:

"(15) shares of any qualified securities subsidiary, subject to the requirements of section 5 of this Act; or"; and

(2) by striking "or" at the end of paragraph 13.

(b) SECURITIES SUBSIDIARIES DEFINED.--Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841), is amended by adding at the end thereof the following new subsection:

"(n) SECURITIES SUBSIDIARIES DEFINED.--For purposes of this Act--

"(1) QUALIFIED SECURITIES SUBSIDIARY.--The term 'qualified securities subsidiary' means any company--

"(A) which--

"(i) is a direct subsidiary of a bank holding company described in subparagraph (C), of an investment banking financing company controlled by a bank holding company described in subparagraph (C), or of another qualified securities subsidiary;

"(ii) is not an insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended) or a subsidiary of an insured depository institution or a company that controls, directly or indirectly, an insured depository institution; and

"(iii) engages solely in the securities and securities-related activities described in Section 5 of this Act; and

"(B) the formation or acquisition of which by the bank holding company has been approved by the Board under section 4(c)(15).

"(2) SECURITIES SUBSIDIARY.--The term 'securities subsidiary' means--

"(A) any qualified securities subsidiary; and

"(B) any subsidiary of any qualified securities subsidiary.".

(c) ESTABLISHMENT AND ACTIVITIES OF QUALIFIED SECURITIES SUBSIDIARY.--The Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841 et seq.), is amended by inserting after section 4 the following new section:

"SECTION 5. SECURITIES AND SECURITIES RELATED ACTIVITIES.

"(a) AUTHORIZED ACTIVITIES FOR QUALIFIED SECURITIES SUBSIDIARY.--A qualified securities subsidiary may--

"(1) engage in underwriting, distributing, or dealing in securities;

"(2) engage in securities brokerage, private placement, investment advisory, financial advisory, or other securities activities not described in paragraph (1) that are permitted under this Act or other applicable law for brokers or dealers registered under the Securities Exchange Act of 1934, as amended, or for investment advisers registered under the Investment Advisers Act of 1940, as amended;

"(3) engage in organizing, sponsoring, managing, or controlling an investment company (as defined in section 3 of the Investment Company Act of 1940, as amended) or in underwriting, distribution, or public or private sale of securities issued by an investment company;

"(4) engage in foreign exchange operations and interest rate and currency swaps;

87

"(5) engage in transactions involving commodities, futures contracts, and options contracts;

"(6) acquire the shares of another qualified securities subsidiary; and

"(7) engage in, or acquire the shares of any company engaged in, any activity which is not described in subparagraphs (1) through (6) of this paragraph if--

"(A) a provision of section 4 of this Act allows a bank holding company or any subsidiary of a bank holding company to engage in, or acquire the shares of any company engaged in, such activity; and

"(B) either--

"(i) the Board permits the bank holding company to engage in, or acquire the shares of a company engaged in, such activity; or

"(ii) such provision of section 4 allows the bank holding company or any subsidiary of a bank holding company to engage in, or acquire the shares of a company engaged in, such activity without the Board's approval.

"(b) FORMATION OF QUALIFIED SECURITIES SUBSIDIARY.--

"(1) BOARD APPROVAL REQUIRED.--It shall be unlawful for any bank holding company directly or indirectly to organize or acquire any shares of a qualified securities subsidiary unless the Board approves, in accordance with the requirements of this section, a written application filed under section 4(c)(15) of this Act. Such an application shall contain such information with respect to the formation or acquisition of a qualified securities subsidiary as the Board may prescribe by regulation.

"(2) PROHIBITION ON APPROVAL UNDER CERTAIN CIRCUMSTANCES.--The Board shall not approve any application under section 4(c)(15) of this Act if the Board determines that --

"(A) the applicant bank holding company has failed to provide information required by regulations prescribed pursuant to paragraph (1) or such additional information as the Board may require the bank holding company to submit in connection with the application; or

"(B) any insured depository institution (as defined in Section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended) controlled by such bank holding company fails, at the time of such application, to meet the risk-based capital guidelines established by the Board with respect to both Tier 1 and Tier 2 capital as such guidelines apply after 1992.

"(3) OPPORTUNITY FOR COMMENT.--The Board shall provide for public notice and opportunity for comment before making any determination with respect to any application under paragraph (1).

"(c) TRANSFER OF SECURITIES AND SECURITIES-RELATED ACTIVITIES FROM OTHER BANK HOLDING COMPANY SUBSIDIARIES TO QUALIFIED SECURITIES SUBSIDIARY.--

"(1) IN GENERAL.--No bank, insured institution, or company controlled by a bank holding company (other than a qualified securities subsidiary or an investment banking financing company) may engage in any activity in which a qualified securities subsidiary may engage pursuant to subsections (a)(1) through (a)(5) of this section; Provided, That any subsidiary engaged, as of the date of enactment of the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991, in any securities activities referred to in Section 20 of the Banking Act of 1933, as amended, pursuant to a written authorization issued by the Board prior to January 1, 1990 may continue to engage in such activities for a period of not more than one year after such date of enactment, notwithstanding that such subsidiary is not a qualified securities subsidiary, so long as the revenues of such subsidiary from all such securities activities shall not exceed 10 percent of the total revenues of such subsidiary during such period, calculated as set forth in the Board's order dated January 18,

1989; Provided Further, That such securities activities shall also be subject to the restrictions described in such order dated January 18, 1989.

"(2) CERTAIN ACTIVITIES NOT INCLUDED.--Paragraph (1) of this subsection shall not apply so as to prohibit any bank, insured institution, or company controlled by a bank holding company from--

"(A) buying or selling, whether as principal or as agent, any security issued by the Secretary of the Treasury under chapter 31, title 31, United States Code;

"(B) buying or selling --

"(i) any security of which the bank, insured institution, or company is the issuer; or

"(ii) any investment security or other investment which the bank, insured institution, or company is authorized under federal law to purchase for its own account;

"(C) buying or selling any security or providing investment advisory or financial advisory services as trustee, executor, administrator, custodian, managing agent, or guardian of estates with respect to the account of a customer; or

"(D) engaging in foreign exchange operations, interest rate swaps, or currency swaps--

(i) for the account of a customer in connection with commercial lending or trade transactions; or

(ii) for its own account, but solely to the extent required for its own interest rate or currency risk management.

"(d) DIVESTMENT REQUIRED IF CAPITAL REQUIREMENTS ARE NOT MET.--In the case of any bank holding company which controls a qualified securities subsidiary, the Board may order such bank holding company to cease conducting any securities activities other than activities in which a national bank may engage under section 5136(b) of the Revised Statutes if the bank holding company fails to meet the Board's Capital Adequacy Guidelines.

"(e) FUNCTIONAL REGULATION.--No provision of this section or section 8 of this Act shall be construed as--

"(1) superseding any provision of any Federal securities law or regulation, or

"(2) limiting the authority of --

"(A) the Board, under section 9 of this Act, to--

"(i) prescribe regulations and issue orders to carry out the purposes of this Act and to prevent evasions of the requirements of this Act or any such regulation or order; and

"(ii) require reports and make examinations for the purposes referred to in clause (i), with respect to any qualified securities subsidiary of a bank holding company; or

"(B) the appropriate Federal banking agency (as defined in Section 3(q) of the Federal Deposit Insurance Act of 1950, as amended), under any other provision of this Act, the Federal Reserve Act, the Federal Deposit Insurance Act, the Home Owners' Loan Act, or any other provision of law, to regulate bank holding companies and their subsidiaries and the transactions between or among any bank holding company, any of its nonbank subsidiaries, and any insured depository institution (as defined in Section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended) controlled by such bank holding company.

SECTION 103. BANK SECURITIES AND INVESTMENT ACTIVITIES.

(a) RESTATEMENT AND REORGANIZATION OF SECTION 5136 OF THE REVISED STATUTES.--

(1) IN GENERAL.--Section 5136 of the Revised Statutes (12 U.S.C. § 24) is amended to read as follows:

"SEC 5136. CORPORATE POWERS OF NATIONAL BANKS.

"(a) GENERAL POWERS.--Upon duly making and filing articles of association and an organization certificate, a national bank shall become, as of the date of the execution of such organization certificate, a corporation which shall have, in the name designated in such certificate, the following powers:

"(1) To adopt and use a corporate seal.

"(2) To have succession from February 25, 1927, or from the date of the execution of such organization certificate (if such date is later than February 25, 1927) until--

"(A) such time as the bank is dissolved by the act of shareholders owning not less than 2/3 of the stock of such bank;

"(B) the franchise is forfeited by reason of violation of law;

"(C) the franchise is forfeited by either a general or a special Act of Congress; or

"(D) the affairs of the bank are placed in the control of the Federal Deposit Insurance Corporation, as receiver, and finally wound up by such Corporation.

"(3) To enter into contracts.

"(4) To sue and be sued in its corporate capacity, and to complain and defend, in any action brought in any court of competent jurisdiction, as fully as natural persons.

"(5) To elect or appoint directors to the board of directors of the bank and, by such board of directors, to --

"(A) appoint a president, vice president, cashier, and other officers;

"(B) define the duties of all such officers;

"(C) require bonds of such officers and fix the penalty of such bonds; and

"(D) dismiss any officer at the pleasure of the directors and appoint another to fill the position.

"(6) To prescribe, by the board of directors, bylaws not inconsistent with law regulating the manner in which--

"(A) stock of the bank may be transferred;

"(B) the directors of the bank are appointed or elected;

"(C) the officers of the bank may be appointed;

"(D) the property of the bank may be transferred;

"(E) the general business of the bank may be conducted; and

"(F) the privileges granted to the bank by law may be exercised and enjoyed.

"(7) To exercise, by the board of directors or officers or agents authorized by such board, and subject to any other provision of law, all such incidental powers as shall be necessary to carry on the business of banking, including, but not limited to--

"(A) discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt;

"(B) receiving deposits;

"(C) buying and selling exchange, coin, and bullion;

"(D) loaning money on personal security; and

"(E) obtaining, issuing, and circulating notes according to the provisions of this title;

Provided, That in no event shall the underwriting of any security (including, without limitation, securities evidencing interests in a pool of assets of a national bank or other asset-backed securities (as defined in paragraph (7) of subsection (b) of this section)) be considered an incidental power within the meaning of this paragraph.

"(8) To contribute to community funds or charitable, philanthropic, or benevolent instrumentalities conducive to the public welfare, such sums as the board of directors may determine to be expedient and in the interests of the national bank, if such bank is not located in a State the laws of which expressly prohibit State banks (as defined in subchapter XV of this Act) from contributing to such funds or instrumentalities.

"(9) To invest in tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment, or furniture, for lease financing transactions on a net lease basis, but such investment may not exceed 10 percent of the assets of the national bank.

"(b) POWERS RELATING TO SECURITIES ACTIVITIES.--

"(1) SECURITIES UNDERWRITING PROHIBITED.--Except as otherwise provided in this subsection or any other provision of law, no national bank may underwrite any issue of securities (including, without limitation, securities evidencing interests in a pool of assets of a national bank or other asset-backed securities (as defined in paragraph (7) of this subsection)).

"(2) BUYING AND SELLING SECURITIES PROHIBITED EXCEPT AS AGENT FOR CUSTOMER.--Except as otherwise provided in this section or any other provision of law, no national bank may buy or sell any security unless the purchase or sale is made--

"(A) as agent for the account of a customer;

"(B) by the bank--

"(i) upon the order of the customer; or

"(ii) in the bank's capacity as trustee, executor, administrator, custodian, managing agent, or guardian of estates with respect to the account of the customer; and

"(C) without recourse to the bank.

"(3) ISSUANCE AND SALE OF CERTAIN GNMA GUARANTEED SECURITIES.--Notwithstanding paragraph (2) or any other provision of this section, a national bank may issue and sell securities which are guaranteed by the Government National Mortgage Association under section 306(g) of the National Housing Act.

"(4) EXCEPTION FOR BANK-ELIGIBLE SECURITIES.-- Paragraphs (1) and (2) of this subsection shall not apply with respect to any bank-eligible security (as defined in paragraph (6) of this subsection), Provided, That subsection (c)(3)(B) shall apply with respect to the aggregate amount of bank-eligible securities described in subparagraphs (N), (O), (P), or (Q) of paragraph (6) of this subsection which may be held by any national bank at any time.

"(5) EXCEPTION FOR CERTAIN BANK SECURITIES AND BANK INVESTMENTS FOR THE BANK'S OWN ACCOUNT.--Paragraph (2) of this subsection shall not apply to the purchase or sale by a national bank of--

"(A) any security of which the national bank is the issuer; or

"(B) any investment security or other security which the bank is purchasing or has purchased for the bank's own account in accordance with subsection (c).

"(6) BANK-ELIGIBLE SECURITY DEFINED.--For purposes of this section, the term "bank-eligible security" means any of the following investment securities:

"(A) Obligations of the United States.

"(B) General obligations of any State or any political subdivision of any State.

"(C) Obligations of the Washington Metropolitan Area Transit Authority which are guaranteed by the Secretary of Transportation under section 9 of the National Capital Transportation Act of 1969.

"(D) Obligations issued--

"(i) under authority of the Federal Farm Loan Act, as amended; or

"(ii) by the thirteen banks for cooperatives, any bank for cooperatives, or the Federal Home Loan Banks.

"(E) Obligations insured by the Secretary of Housing and Urban Development under title XI of the National Housing Act.

"(F) Obligations insured by the Secretary of Housing and Urban Development pursuant to section 207 of the National Housing Act, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States.

"(G) Obligations, participations, or other instruments of or issued by the Federal National Mortgage Association or the Government National Mortgage Association.

89

"(H) Mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 305 or section 306 of the Federal Home Loan Mortgage Corporation Act.

"(I) Obligations of the Federal Financing Bank.

"(J) Obligations of the Environmental Financing Authority.

"(K) Obligations or other instruments or securities of the Student Loan Marketing Association.

"(L) Such obligations of any local public agency (as defined in section 110(h) of the Housing Act of 1949) as are secured by an agreement between the local public agency and the Secretary of Housing and Urban Development in which the local public agency agrees to borrow from the Secretary, and the Secretary agrees to lend to such local public agency, monies in an aggregate amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay, when due, the interest on and all installments (including the final installment) of the principal of such obligations, which monies under the terms of said agreement are required to be used for such payments.

"(M) Such obligations of a public housing agency (as defined in the United States Housing Act of 1937) as are secured--

"(i) by an agreement between such agency and the Secretary of Housing and Urban Development in which the agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the agency, prior to the maturity of such obligations, monies in an amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay the principal of such obligations with interest to maturity thereon, which monies under the terms of said agreement are required to be used for the purpose of paying the principal of and the interest on such obligations at their maturity;

"(ii) by a pledge of annual contributions under an annual contributions contract between such agency and the Secretary if such contract shall contain the covenant by the Secretary which is authorized by section 6(g) of the United States Housing Act of 1937, as amended, and if the maximum sum and the maximum period specified in such contract pursuant to such section 6(g) shall not be less than the annual amount and the period for payment which are requisite to provide for the payment when due of all installments of principal and interest on such obligations; or

"(iii) by a pledge of both annual contributions under an annual contributions contract containing the covenant by the Secretary of Housing and Urban Development which is authorized by section 6(g) of the United States Housing Act of 1937, as amended, and a loan under an agreement between such agency and the Secretary in which the agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the agency, prior to the maturity of the obligations involved, monies in an amount which (together with any other monies irrevocably committed under the annual contributions contract to the payment of principal and interest on such obligations) will suffice to provide for the payment when due of all installments of principal and interest on such obligations, which monies under the terms of the agreement are required to be used for the purpose of paying the principal and interest on such obligations at their maturity.

"(N) Obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, or the Inter-American Investment Corporation.

"(O) Obligations issued by any State or political subdivision or any agency of a State or political subdivision for housing, university, or dormitory purposes, which are at the time eligible for purchase by a national bank for its own account.

"(P) Obligations issued by the Tennessee Valley Authority.

"(Q) Obligations issued by the United States Postal Service.

"(K) Debt obligations backed by the federal government of Canada, by any Province of Canada (including, without limitation, the Yukon Territory and the Northwest Territories and their successors), or by any political subdivision of any such Province to a degree which is comparable to the liability of the United States, any State, or any political subdivision thereof for any obligation which is backed by the full faith and credit of the United States, such State, or such political subdivision, including, without limitation, any debt obligation of any agent of Canada or any such Province or any political subdivision of such Province if --

"(i) the obligation of the agent is assumed in such agent's capacity as agent for Canada or such Province or such political subdivision; and

"(ii) Canada, such Province, or such political subdivision on whose behalf such agent is acting with respect to such obligation is ultimately and unconditionally liable for such obligation.

"(7) SECURITY DEFINED.--For purposes of this section, the term "security" shall have the meaning given to that term in Section 2(1) of the Securities Act of 1933, as amended, but shall not include any security issued by a bank in the ordinary course of any of the following banking activities:

"(A) discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt;

"(B) receiving deposits;

"(C) buying and selling exchange, coin, and bullion;

"(D) loaning money on personal security; and

"(E) obtaining, issuing, and circulating notes according to the provisions of this title.

"(8) ASSET-BACKED SECURITY DEFINED.--For purposes of this section, the term "asset-backed securities" means securities which represent interests in, or are secured by, notes, drafts, acceptances, loans, leases, receivables, other obligations, or pools of any such obligations, if the securities provide for payment of obligations no greater in the aggregate than the underlying payment obligations and irrespective of whether the underlying payment obligations are originated by the issuer of the securities or any affiliate thereof.

"(c) PURCHASE OF SECURITIES FOR THE BANK'S OWN ACCOUNT.--Any national bank may purchase for its own account investment securities or other securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe, subject to the following limitations:

"(1) CORPORATE STOCK.--Except as provided in any other provision of law, no national bank may buy, for its own account, any share of stock of any corporation (other than shares of a corporation described in any other paragraph of this subsection).

"(2) MAXIMUM INVESTMENT AMOUNT FOR SECURITIES ISSUED BY ANY SINGLE ISSUER.--The total amount of investment securities held by the bank (for the bank's own account) which were issued by any one person, or for which such person is the obligor or maker, may not exceed at any time the amount which is equal to the sum of--

"(A) 10 percent of the capital stock of the bank which is actually paid in and unimpaired; and

"(B) 10 percent of the bank's unimpaired surplus fund --

except that this subparagraph shall not require any national bank to dispose of investment securities it lawfully held on August 23, 1935.

"(3) BANKERS' BANKS.--

"(A) ACQUISITION OF SHARES ALLOWED.--Any national bank may purchase, for its own account, shares of an insured bank (as defined in section 3(h) of the Federal Deposit Insurance Act of 1950, as amended) or a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956, as amended) if --

"(i) the outstanding shares of such bank or company are owned exclusively (except to the extent of directors' qualifying shares required by law) by depository institutions (as defined in clauses (i) through (vi) of section 19(b)(1)(A) of the Federal Reserve Act, as amended) or depository institution holding companies; and

90

"(ii) such bank or company, and all subsidiaries of such bank or company, are engaged exclusively in providing services for other depository institutions and officers, directors, and employees of depository institutions.

"(B) MAXIMUM INVESTMENT AMOUNT.--The total amount of stock held by any national bank in any bank or holding company referred to in subparagraph (A)--

"(i) may not exceed, at any time, 10 percent of the national bank's capital stock and paid in and unimpaired surplus; and

"(ii) may not include more than 5 percent of any class of voting securities of such bank or company.

"(4) BANK-ELIGIBLE SECURITIES.--

"(A) IN GENERAL.--Subject to the requirements of this section and to such other requirements as may be imposed, in the case of an individual institution, for safety and soundness reasons pursuant to section 8 of the Federal Deposit Insurance Act of 1950, as amended, a national bank may purchase, for its own account, any bank-eligible securities.

"(B) MAXIMUM INVESTMENT AMOUNT IN THE CASE OF CERTAIN SECURITIES.--The total amount of bank-eligible securities described in subparagraphs (N), (O), (P), or (Q) of subsection (b)(6) which may be held by any national bank at any time--

"(i) in connection with being an underwriter of such securities or buying and selling, as principal, such securities under subsection (b); or

"(ii) for the bank's own account --

shall not exceed an amount equal to the sum of 10 percent of the capital stock of the national bank actually paid in and unimpaired and 10 percent of the bank's unimpaired surplus fund.

"(C) SPECIAL RULE FOR CERTAIN COMMITMENTS.--For purposes of subparagraph (B), any bank-eligible securities referred to in such subparagraph as to which any national bank is under a commitment shall be deemed to be held by such national bank.

"(5) MORTGAGE-RELATED SECURITIES--

"(A) IN GENERAL.--Subject to the requirements of this section and to such other requirements as may be imposed, in the case of an individual institution, for safety and soundness reasons pursuant to section 8 of the Federal Deposit Insurance Act of 1950, as amended, a national bank may purchase, for its own account, any of the following securities:

"(i) Securities offered and sold pursuant to section 4(5) of the Securities Act of 1933, as amended.

"(ii) Mortgage-related securities (as defined in section 3(a)(41) of the Securities Exchange Act of 1934, as amended).

"(B) REGULATIONS.--Any purchase by a national bank of securities described in subparagraph (A) shall be subject to such limitations and restrictions as the Comptroller of the Currency may prescribe by regulation, including regulations prescribing--

"(i) the minimum size of the issue (at the time of initial distribution) with respect to any such security; and

"(ii) minimum aggregate sale prices with respect to any such security,

which must be met or exceeded in order for a national bank to be eligible to purchase such securities without limitation pursuant to subparagraph (A).

"(6) SAFE-DEPOSIT BUSINESS.--

"(A) ACQUISITION OF SHARES ALLOWED.--In connection with a national bank's carrying on the business commonly known as the safe-deposit business, such bank may, subject to the requirements of this paragraph, invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business.

"(B) MAXIMUM INVESTMENT AMOUNT.--The total amount of stock held by any national bank in any one or more corporations referred to in subparagraph (A) shall not exceed an amount equal to the sum of--

"(i) 15 percent of the capital stock of the national bank actually paid in and unimpaired; and

"(ii) 15 percent of the bank's unimpaired surplus fund.

"(7) ACQUISITION OF SHARES OF NATIONAL HOUSING CORPORATIONS ALLOWED; ETC.--A national bank may --

"(A) Purchase for its own account shares of stock issued by a corporation authorized to be created pursuant to title IX of the Housing and Urban Development Act of 1968, as amended.

"(B) Make investments in a partnership, limited partnership, or joint venture formed pursuant to section 907(a) or 907(c) of such Act.

"(8) STATE HOUSING CORPORATIONS.--

"(A) ACQUISITION OF SHARES AND OTHER INVESTMENTS ALLOWED.--A national bank may --

"(i) Purchase for its own account shares of stock issued by any State housing corporation incorporated in the State in which the national bank is located.

"(ii) Make investments in loans and commitments for loans to any such corporation.

"(B) MAXIMUM INVESTMENT AMOUNT.--The total amount of stock held by a national bank in any corporation referred to in subparagraph (A), and the amount of investments in loans and commitments for loans to such corporation by the bank, shall not in the aggregate exceed an amount equal to the sum of--

"(i) 5 percent of the national bank's capital stock actually paid in and unimpaired; and

"(ii) 5 percent of the bank's unimpaired surplus fund.

"(9) AGRICULTURAL CREDIT CORPORATIONS.--

"(A) ACQUISITION OF SHARES AND OTHER INVESTMENTS ALLOWED.--A national bank may purchase for its own account shares of stock issued by a corporation organized solely for the purpose of making loans to farmers and ranchers for agricultural purposes, including the breeding, raising, fattening, or marketing of livestock.

"(B) MAXIMUM INVESTMENT AMOUNT.--Unless the national bank owns at least 80 percent of the stock of an agricultural credit corporation described in subparagraph (A), the total amount invested by the national bank at any one time in the stock of any one or more of such corporations shall not exceed an amount equal to 20 percent of the bank's unimpaired capital and surplus.

"(10) OPERATIONS SUBSIDIARIES. --A national bank may own voting stock in a corporation which engages solely in activities which are a part of the business of banking or are incidental thereto, in accordance with such requirements and limitations as may be prescribed, by regulation or order, by the Comptroller of the Currency; Provided, That the bank must own at least 80 percent of every class of voting stock of such corporation.

"(11) ADDITIONAL LIMITATIONS PRESCRIBED IN REGULATIONS.--The authority of any national bank under this section to buy investment securities for the bank's own account shall be subject to such additional limitations and restrictions as the Comptroller of the Currency may prescribe by regulation.

"(12) INVESTMENT SECURITIES DEFINED.--For purposes of this section, the term "investment securities" means marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes, and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency."

(2) RULE OF CONSTRUCTION.--The provisions of subsection (a) and of paragraphs (1) through (6), inclusive, of subsection (b) of section 5136 of the Revised Statutes, as amended by paragraph (1) of this Section 103(a) of the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991--

(A) may not be construed as making any substantive change in the meaning of any provision of such section (as in effect on the day before the effective date of such amendment); and

(B) shall not affect any regulation prescribed, any order issued, or any action taken before the effective date of such amendment under or pursuant to such section (as in effect on the day before such date).

(b) LIMITATION ON SECURITIES AFFILIATIONS OF INSURED BANKS.--Section 18(j)(3) of the Federal Deposit Insurance Act of 1950, as amended (12 U.S.C. § 1828(j)(3)), is amended --

(1) by striking out subparagraph (C) and inserting in lieu thereof the following new subparagraph:

"(C)TRANSITION RULE.--Notwithstanding subparagraph (A), any affiliation of an insured bank with any company which is prohibited under such subparagraph may continue until the earlier of --

"(i) the date a qualified securities subsidiary (as defined in section 2(n)(1) of the Bank Holding Company Act of 1956, as amended) which is an affiliate of such bank commences operations; or

"(ii) the end of the 2-year period beginning on the date of the enactment of the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991.";

(2) in subparagraph (E), by deleting the words "subparagraph (D), (F), or (I) of"; and

(3) by striking out subparagraph (F).

(c) TECHNICAL AND CONFORMING AMENDMENTS.

(1) The 20th paragraph of section 9 of the Federal Reserve Act (12 U.S.C. § 335) is amended by striking out "paragraph 'Seventh' of" and inserting in lieu thereof "subsections (b) and (c) of".

(2) Section 514 of the National Housing Act (12 U.S.C. § 1733) is amended by striking out "paragraph seventh of" and inserting in lieu thereof "subsection (b) of".

(3) Section 4(g)(1) of the International Banking Act of 1978, as amended (12 U.S.C. § 3102(g)(1)), is amended by striking out "paragraph 'Seventh' of" and inserting in lieu thereof "subsection (b) of".

(4) Section 18(j)(4)(A) of the Federal Deposit Insurance Act of 1950, as amended (12 U.S.C. § 1828(j)(4)(A)), is amended by striking out "or any provision of section 377 of this title" and inserting in lieu thereof "or any provision of paragraph (3) of this subsection".

SECTION 104. TRANSFER OF FOREIGN SECURITIES AND SECURITIES-RELATED ACTIVITIES OF UNITED STATES BANKING ORGANIZATIONS TO QUALIFIED SECURITIES SUBSIDIARIES.

(a) The 7th full paragraph of section 25 of the Federal Reserve Act (12 U.S.C. § 604a) is amended by adding at the end thereof the following new sentence: "Any activities authorized by regulations issued by the Board of Governors of the Federal Reserve System under this section shall be subject to the requirements of section 5(c) of the Bank Holding Company Act of 1956, as amended."

(b) Section 4(c)(13) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1843(c)(13)), is amended by inserting prior to the semi-colon a comma, followed by the words: "provided, that the activities of any such company shall be subject to section 5(c) of this Act".

SECTION 105. BANK HOLDING COMPANY FORMATION THROUGH REORGANIZATIONS.

(a) EXCEPTION TO APPROVAL REQUIREMENTS IN CONNECTION WITH CERTAIN BANK REORGANIZATIONS. -- The second sentence of section 3(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1842(a)), is amended --

(1) by striking out "or (B)" and inserting in lieu thereof "(B)"; and

(2) by inserting before the period at the end thereof the following: "; or (C) the acquisition by a company of control of a bank in connection with a reorganization described in paragraph (1) of subsection (h) if the requirements of such subsection are met."

(b) EXPEDITED PROCEDURES FOR CERTAIN REORGANIZATIONS OF BANKS INTO HOLDING COMPANIES. -- Section 3 of the Bank Holding Company act of 1956, as amended (12 U.S.C. § 1842), is amended by adding at the end thereof the following new subsection:

"(h) EXPEDITED PROCEDURES FOR CERTAIN REORGANIZATIONS OF BANKS INTO HOLDING COMPANIES. --

(1) REORGANIZATION DESCRIBED. -- For purposes of subparagraph (C) of the second sentence of subsection (a), a reorganization is described in this paragraph if --

"(A) any person or any group of persons exchange the shares of a bank which are held by any such person for shares of a newly formed bank holding company;

"(B) each such person holds, after such exchange, substantially the same proportionate interest in the bank holding company as each such person held in the bank before such exchange, except for any change in the shareholders' proportionate interest in such holding company which resulted from the exercise of dissenting shareholders' rights under State or Federal law; and

"(C) immediately following the reorganization, the resulting bank holding company meets at least the minimum capital and other financial standards prescribed by the Board by regulation for a bank holding company.

"(2) EXPEDITED PROCEDURE. -- The exception provided by subparagraph (C) of the second sentence of subsection (a) to the approval requirement of such subsection shall apply with respect to a reorganization described in paragraph (1) of the subsection, if --

"(A) the bank referred to in paragraph (1)(A) provides notice to the Board of such reorganization at least 30 days before the date on which such reorganization is scheduled to begin; and

"(B) the Board has not--

"(i) issued an order before such date disapproving such reorganization; or

"(ii) issued a notice before such date that the provisions of this subsection are not applicable to such reorganization by reason of paragraph (3).

"(3) EXCEPTION IN CASE OF CERTAIN NONBANKING ACTIVITIES.-- This subsection shall not apply to any reorganization described in paragraph (1) if, immediately after such reorganization, the bank holding company would be engaging, directly or indirectly, in any activity other than banking (and those activities determined to be incidental to the business of banking within the meaning of subsection (a)(7) of Section 5136 of the Revised Statutes) or managing and controlling banks.

"(4) CAPITAL REQUIREMENT. -- In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank resulting from a reorganization described in paragraph (1) of this subsection immediately following such reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company."

92

42-559 O - 91 - 4

TITLE II – INVESTMENT BANKING FINANCING COMPANIES.

Subtitle A - Creation of Investment Banking Financing Companies

SECTION 201. SHORT TITLE.

This subtitle may be cited as the "Investment Banking Financing Company Act of 1991."

SECTION 202. INVESTMENT BANKING FINANCING COMPANIES.

(a) CHARTERING OF INVESTMENT BANKING FINANCING COMPANY.--Any bank holding company (as defined in Section 2(a) of the Bank Holding Company Act of 1956, as amended), broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934, as amended), or dealer (as defined in Section 3(a)(5) of the Securities Exchange Act of 1934, as amended), or any affiliate of such broker or dealer, may apply to the Comptroller of the Currency, on such forms and in accordance with such procedures as the Comptroller may prescribe by regulation, for permission to organize an investment banking financing company; Provided, That the organization of an investment banking financing company by a bank holding company shall also be subject to the requirements of Section 7 of the Bank Holding Company Act of 1956, as amended (and as redesignated by the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991). Upon approval of the application, such investment banking financing company shall be a body corporate, chartered under the laws of the United States by the Comptroller. The investment banking financing company shall operate, pursuant to the requirements of this Act, at the direction of a board of directors elected at an organizational meeting to be held, as soon as practicable after issuance by the Comptroller of a charter, by such bank holding company, broker, or dealer for the purpose of electing such board of directors and taking such other action necessary, pursuant to the charter and the regulations issued by the Comptroller, to complete the corporate organization of the investment banking financing company. Immediately following their election, the board of directors shall meet to elect the officers of the investment banking financing company and to take such other action, as prescribed by the Comptroller, to complete the corporate organization of such investment banking financing company.

(b) UNAUTHORIZED ORGANIZATION PROHIBITED.--No person may organize an investment banking financing company, collect money from others for such purpose, or represent himself as authorized to do so, and no investment banking financing company shall transact any business prior to completion of its organization, except as provided in this Act and in implementing regulations of the Comptroller.

(c) AUTHORIZED ACTIVITIES FOR INVESTMENT BANKING FINANCING COMPANY.--Subject to the provisions of subsections (d) and (e) of this section, an investment banking financing company may exercise, in accordance with its articles of organization and such regulations as are issued by the Comptroller, all of the powers and privileges of a national banking association. Notwithstanding any other provision of law, an investment banking financing company may acquire, directly or indirectly, the shares of one or more qualified securities subsidiaries (as defined in subsection (f) of this section).

(d) LIMITATIONS ON ACTIVITIES OF INVESTMENT BANKING FINANCING COMPANY.--No investment banking financing company may:

(1) become an 'insured depository institution' within the meaning of section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended, or an 'insured credit union' within the meaning of section 2(7) of the Federal Credit Union Act of 1934, as amended, or acquire (directly or indirectly) control of such an insured depository institution or insured credit union; or

(2) permit any customer to open a deposit account with less than $100,000.

(e) CAPITAL.--The capital of an investment banking financing company shall be maintained at all times at such level and in such a manner as may be prescribed by the Comptroller by regulation.

(f) QUALIFIED SECURITIES SUBSIDIARY DEFINED.--A qualified securities subsidiary is any company which is wholly owned by an investment banking financing company or by a wholly-owned subsidiary thereof (including another qualified securities subsidiary) and is any one or more of the following:

(1) a broker or dealer registered under the Securities Exchange Act of 1934, as amended, or the Commodities Exchange Act of 1936, as amended;

(2) an investment company registered under the Investment Company Act of 1940, as amended; or

(3) an investment adviser registered under the Investment Advisers Act of 1940, as amended.

Notwithstanding the provisions of this subsection, a qualified securities subsidiary controlled, directly or indirectly, by a bank holding company registered under the Bank Holding Company Act of 1956, as amended, shall be subject to the requirements of the applicable provisions of that Act. Notwithstanding any other provision of law, no qualified securities subsidiary may become an "insured depository institution" within the meaning of section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended, or an "insured credit union" within the meaning of section 2(7) of the Federal Credit Union Act of 1934, as amended, or a company that controls (directly or indirectly) such an insured depository institution or insured credit union.

(g) IMPLEMENTING REGULATIONS.--The Comptroller shall promulgate such regulations as may be necessary to implement the provisions of this section.

SECTION 203. REGULATION AND SUPERVISION OF INVESTMENT BANKING FINANCING COMPANIES AND QUALIFIED SECURITIES SUBSIDIARIES.

(a) STATEMENT OF PURPOSE.--Whereas it is the intent of Congress that individual financial services businesses within a diversified holding company or conglomerate-type corporate complex should be functionally regulated and that overlapping regulation and supervision of the same activity, which leads to conflicts of jurisdiction, should be avoided, the following provisions of this section shall be interpreted in accordance with this overarching congressional purpose.

(b) REGULATION AND SUPERVISION OF INVESTMENT BANKING FINANCING COMPANIES.--

(1) AUTHORITY VESTED IN COMPTROLLER OF THE CURRENCY.--Notwithstanding any other provision of law, the authority to regulate and supervise the activities of investment banking financing companies shall be vested exclusively in the Comptroller of the Currency; Provided, That nothing in this paragraph shall be construed to vest in the Comptroller any authority to regulate or supervise the activities of any qualified securities subsidiary of an investment banking financing company or of any broker, dealer, or bank holding company which controls an investment banking financing company.

(2) EXAMINATIONS.--Each investment banking financing company and each subsidiary thereof (other than a qualified securities subsidiary) shall be subject to such examinations and to such reporting and recordkeeping requirements as the Comptroller may prescribe. The cost of examinations shall be assessed against and paid by such investment banking financing company. Examiners appointed by the Comptroller for the purposes of this Act shall be subject to the same requirements, responsibilities, and penalties as are applicable to examiners under the Federal Reserve Act and title LXII of the Revised Statutes and shall have, in the exercise of functions under this Act, the same powers and privileges as are vested in such examiners by law. If any investment banking financing company fails to pay any assessment required under this subsection within 60 days of the date of such assessment, or refuses to permit any examiner appointed by the Comptroller to make an examination, or refuses to provide any information required to be disclosed by regulation or in the course of any examination, or submits or publishes any false or misleading report or information, the Comptroller may assess against such investment banking financing company a civil penalty of not more than $5,000 for each day any such failure or refusal continues. Any such civil penalty shall be assessed and collected by the Comptroller in the manner prescribed in subparagraphs (E), (F), (G), (I), and (J) of section 8(i)(2) of the Federal Deposit Insurance Act of 1950, as amended, for penalties imposed under such section, and any such assessment shall be also subject to the provisions of subparagraph (H) of that section and of section 8(h) of that Act.

(3) ENFORCEMENT.--

(A) CAPITAL.--If any investment banking financing company fails to maintain capital at or above the minimum level prescribed by the Comptroller's regulations, the Comptroller may issue a directive requiring the investment banking financing company to submit and adhere to a plan for increasing capital which is acceptable to the Comptroller. Any such directive, and any such plan when approved by the Comptroller, shall be enforceable as provided in this paragraph.

(B) CEASE-AND-DESIST AUTHORITY.--If an investment banking financing company subject to a capital directive issued pursuant to subparagraph (A) fails to submit or adhere to a plan for increasing capital which is acceptable to the Comptroller, or if the Comptroller has reasonable cause to believe that any investment banking financing company has permitted any customer to open a deposit account with less than $100,000 or has taken any action which has caused it to become an "insured depository institution" within the meaning of section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended, or an "insured credit union" within the meaning of section 2(7) of the Federal Credit Union Act of 1934, as amended, or has represented to any person that any deposit accepted by such investment banking financing company is an "insured deposit" within the meaning of section 3(m) of the Federal Deposit Insurance Act of 1950, as amended, or a "member account" of an "insured credit union" within the meaning of sections 2(5) and 2(7) of the Federal Credit Union Act of 1934, as amended, the Comptroller may issue and serve upon such investment banking financing company a notice of charges, which shall contain a statement of the facts constituting the alleged violation or violations of this Act and shall fix a time and a place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the investment banking financing company. Such hearing shall be fixed for a date not earlier than 30 days nor later than 60 days after service of such notice unless an earlier or later date is set by the Comptroller at the request of the investment banking financing company so served. Unless the company so served shall appear at the hearing, it shall be deemed to have consented to the issuance of the cease-and-desist order. In the event of such consent, or if upon the record made at any such hearing the Comptroller shall find that any violation or violations specified in the notice of charges has or have been established, the Comptroller may issue an order to cease and desist from any such violation or violations and, in an appropriate case, as determined by the Comptroller in his discretion, to take affirmative action to correct the conditions resulting from any such violation or violations. Such order shall become effective at the expiration of 30 days after service thereof upon the investment banking financing company (except in the case of a cease-and-desist order issued upon consent, which shall become effective at the time specified therein), and shall remain effective and enforceable as provided therein, except as stayed, modified, terminated, or set aside by action of the Comptroller or a reviewing court. Any hearing provided for in this subsection, and judicial review of any final cease-and-desist order (other than a cease-and-desist order issued upon consent, which shall be unreviewable) shall be in accordance with the provisions of section 8(h) of the Federal Deposit Insurance Act of 1950, as amended.

(C) CIVIL MONEY PENALTY.--Any person who violates, or who causes an investment banking financing company to violate any final cease-and-desist order issued pursuant to subparagraph (B) shall forfeit and pay a civil penalty of not more than $100,000 for each day during which such violation continues. Any such civil penalty shall be assessed and collected by the Comptroller in the manner provided in subparagraphs (E), (F), (G), (I), and (J) of section 8(i)(2) of the Federal Deposit Insurance Act of 1950, as amended, and any such assessment shall be subject to the provisions of subparagraph (H) of that section and of section 8(h) of that Act.

(D) CHARTER REVOCATION.--If the Comptroller determines that any investment banking financing company has violated any cease-and-desist order which was issued under subparagraph (B) of this paragraph and which has become final, the Comptroller may, in addition to or in lieu of any other remedies provided by law, issue an order revoking the charter of such

investment banking financing company. Any order revoking the charter of an investment banking financing company shall be effective within 20 days of service upon such investment banking financing company unless stayed, modified, terminated, or set aside by a court in proceedings authorized in this subparagraph. The investment banking financing company shall give notice of such revocation order to each of its depositors in such manner and at such times as the Comptroller may deem necessary and may order for the protection of the depositors. Any investment banking financing company served with an order revoking its charter may, within 10 days of the date of service of such order, apply to the United States District Court for the District of Columbia, or the United States District Court for the judicial district in which the home office of such investment banking financing company is located, for an injunction setting aside, limiting, modifying, or suspending the enforcement, operation, or effectiveness of such order, and such court shall have jurisdiction to issue such injunction. Failure to seek judicial review within such 10-day period shall constitute a waiver thereof and shall constitute consent by the bank holding company, broker, or dealer, as the case may be, which controls such investment banking financing company to the issuance of a final order of revocation of its charter.

(c) REGULATION AND SUPERVISION OF QUALIFIED SECURITIES SUBSIDIARIES.--The authority to regulate and supervise the activities of a qualified securities subsidiary shall be vested in --

(1) the Commodities Futures Trading Commission, with respect to any activities as to which such qualified securities subsidiary is registered (or is required to register) under the Commodities Exchange Act of 1936, as amended; and

(2) the Securities and Exchange Commission, with respect to activities as to which such qualified securities subsidiary is registered (or is required to register) under the Securities Exchange Act of 1934, as amended, the Investment Company Act of 1940, as amended, or the Investment Advisers Act of 1940, as amended.

Nothing contained in this subsection shall be construed as detracting to any extent from the jurisdiction which any state regulatory authority, exchange (as defined in section 3(a)(1) of the Securities Exchange Act of 1934, as amended), or self-regulatory organization (as defined in section 3(a)(26) of the Securities Exchange Act of 1934, as amended) may exercise over any of the activities of any qualified securities subsidiary.

94

SEC. 204. EFFECT ON CERTAIN STATE LAWS.

(a) ANTI-AFFILIATION STATUTES PROHIBITED.--No State may, directly or indirectly, prohibit, prevent, or impede--

(1) any insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended), or any affiliate, agent, principal, broker, director, officer, employee, or other representative of any such institution from being owned or controlled by, under common ownership or control with, or otherwise affiliated with any broker (as defined in section 3(a)(4) of the Securities Exchange Act of 1934, as amended), dealer (as defined in section 3(a)(5) of the Securities Exchange Act of 1934, as amended), or investment banking financing company (as defined in section 2(o) of the Bank Holding Company Act of 1956, as amended); or

(2) any such investment banking financing company (or any affiliate, agent, principal, broker, director, officer, employee, or other representative thereof) from being owned or controlled by, under common ownership or control with, or otherwise affiliated with any such broker or dealer.

(b) DIFFERENTIAL TREATMENT PROHIBITED.--Notwithstanding any other provision of law, no State may, directly or indirectly, cause any differential treatment to be accorded to any such insured depository institution, investment banking financing company, broker, or dealer solely by reason of any such ownership, control, common ownership or control, or affiliation.

Subtitle B - INVESTMENT BANKING FINANCING COMPANY SUBSIDIARIES OF BANK HOLDING COMPANIES

SECTION 211. INVESTMENT BANKING FINANCING COMPANY SUBSIDIARIES OF BANK HOLDING COMPANIES AUTHORIZED.

(a) INVESTMENT BANKING FINANCING COMPANY SUBSIDIARY OF BANK HOLDING COMPANY ALLOWED.--Section 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1843(c)), is amended by inserting after paragraph (15) the following new paragraph:

"(16) shares of any investment banking financing company, subject to the requirements of section 7 of this Act."

(b) INVESTMENT BANKING FINANCING COMPANY DEFINED.--Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841), is amended by adding at the end thereof the following new subsection:

"(o) INVESTMENT BANKING FINANCING COMPANY.--The term 'investment banking financing company' means any company--

"(1) which--

"(i) is not a subsidiary of an insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended) and does not control an insured depository institution; and

"(ii) is chartered by the Comptroller of the Currency pursuant to the Investment Banking Financing Company Act of 1991 and engages in such activities, and is subject to such limitations, as are prescribed by the Comptroller pursuant thereto.

"(2) the formation or acquisition of which, in the case of such a company to be controlled by a bank holding company, has been approved by the Board as provided in section 7 of this Act.

(c) EXCLUSION FROM DEFINITION OF "BANK".--Section 2(c)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841(c)(2)), is amended by adding at the end thereof the following new subparagraph:

"(K) An investment banking financing company (as defined in subsection (o) of this section.)"

(d) ESTABLISHMENT AND ACTIVITIES OF INVESTMENT BANKING FINANCING COMPANY.--The Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841 et seq.), is amended by inserting after section 6 (as redesignated by section 2 of the Taxpayer Protection, Capital Markets Reform, and International Competitiveness Act of 1991) the following new section:

"SECTION 7. FORMATION OF INVESTMENT BANKING FINANCING COMPANY.

"(a) BOARD APPROVAL REQUIRED.--Notwithstanding compliance with the requirements of the Investment Banking Financing Company Act of 1991, it shall be unlawful for any bank holding company directly or indirectly to organize or acquire control of any class of voting stock of an investment banking financing company unless the Board approves, in accordance with the requirements of this section, a written application filed under section 4(c)(16) of this Act. Such an application shall contain such information with respect to the formation or acquisition of an investment banking financing company as the Board may prescribe by regulation.

"(b) PROHIBITION ON APPROVAL UNDER CERTAIN CIRCUMSTANCES.--The Board shall not approve any application under section 4(c)(16) of this Act with respect to the proposed establishment of an investment banking financing company by a bank holding company if the Board determines that --

"(1) the applicant bank holding company has failed to provide information required by regulations prescribed pursuant to subsection (a) or such additional information as the Board may require the bank holding company to submit in connection with the application; or

"(2) any insured depository institution (as defined in Section 3(c)(2) of the Federal Deposit Insurance Act of 1950, as amended) controlled by such bank holding company fails at the time of such

application or, based upon the record of such application (including the Board's evaluation of any commitments by the applicant to increase the capital of such insured depository institution), upon consummation of the proposed transaction will fail, to meet the risk-based capital guidelines established by the appropriate Federal banking agency (as defined in Section 3(q) of the Federal Deposit Insurance Act of 1950, as amended) with respect to both Tier 1 and Tier 2 capital as such guidelines apply after 1992.

"(c) OPPORTUNITY FOR COMMENT.--The Board shall provide for public notice and opportunity for comment before making any determination with respect to any application under section 4(c)(16) of this Act.

SECTION 212. RESERVE REQUIREMENTS.

(a) AMENDMENT TO DEFINITION OF DEPOSITORY INSTITUTION.--Section 19(b)(1)(A) of the Federal Reserve Act (12 U.S.C. § 461(b)(1)(A)) is amended--

(1) by striking out "and" at the end of clause (vi);

(2) by striking out the period at the end of clause (vii) and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(viii) any investment banking financing company as defined in section 2(c)(2)(K) of the Bank Holding Company Act of 1956, as amended.".

(b) AUTHORITY TO IMPOSE RESERVE REQUIREMENTS WITH RESPECT TO TRANSACTION ACCOUNTS HELD BY INVESTMENT BANKING FINANCING COMPANIES.--Section 19(b)(2) of the Federal Reserve Act (12 U.S.C. § 461(b)(2)) is amended by adding at the end thereof the following:

"(E) Notwithstanding any other provision of this paragraph, depository institutions described in subparagraph (1)(A)(viii) shall not be required to maintain reserves against deposits.

(c) DISCOUNT AND BORROWING PRIVILEGES OF INVESTMENT BANKING FINANCING COMPANIES.--Section 19(b)(7) of the Federal Reserve Act (12 U.S.C. § 461(b)(7)) is amended by adding at the end thereof the following sentence: "Notwithstanding the first sentence of this subparagraph (7), depository institutions described in subparagraph (1)(A)(viii) shall not be entitled to the same discount and borrowing privileges as member banks except to the extent other provisions of law specifically confer such privileges to such depository institutions."

Subtitle C - Retail Insured Banks

SECTION 221. SHORT TITLE.

This subtitle may be cited as the "Retail Insured Bank Act of 1991."

SECTION 222. AUTHORIZATION FOR CERTAIN ORGANIZATIONS TO ESTABLISH RETAIL INSURED BANKS.

(a) DEFINITION OF RETAIL INSURED BANK.--Section 2(c)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841(c)(2)), is amended by adding at the end thereof the following new subparagraph:

"(L) A retail insured bank, which--

"(i) is an insured bank (as defined in section 3(b) of the Federal Deposit Insurance Act of 1950, as amended);

"(ii) is an affiliate of a broker (as defined in section 3(a)(4) of the Securities Exchange Act of 1934, as amended) or of a dealer (as defined in section 3(a)(5) of such Act); and

"(iii) engages solely in the business of accepting deposits and providing traditional banking services (including, without limitation, loans, discounts, and trust services) for personal, family, or household purposes (including loans for the purpose of purchasing or carrying

securities within the purview of section 7 of the Securities Exchange Act of 1934, as amended) and does not engage in the business of making commercial loans.

(b) TYING PROHIBITED.--Section 4(h) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1843(h)), is amended by striking out 'or (J)' at each place it appears in paragraphs (1) and (2) of such section and inserting in its place '(J), or (L)'.

TITLE III -- BANK, CONSUMER AND MARKET INTEGRITY SAFEGUARD PROVISIONS.

SECTION 301. BANK SAFETY AND SOUNDNESS.

The Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841 et seq.), is amended by inserting after section 7 (as redesignated by section 2 of this Act) the following new section:

"SECTION 8. TAXPAYER PROTECTION PROVISIONS AND OTHER REQUIREMENTS APPLICABLE IN THE CASE OF BANK HOLDING COMPANIES WITH SECURITIES SUBSIDIARIES

"(a) CERTAIN FINANCIAL TRANSACTIONS BETWEEN INSURED DEPOSITORY INSTITUTIONS AND AFFILIATED INVESTMENT BANKING FINANCING COMPANIES OR SECURITIES SUBSIDIARIES PROHIBITED.--No bank or insured institution controlled by a bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

"(1) Except as provided in subsection (m) of this section, extend credit in any manner to the investment banking financing company or securities subsidiary.

"(2) Purchase for the bank's or insured institution's own account, or for the account of any subsidiary of the bank or insured institution, any financial asset of the investment banking financing company or securities subsidiary.

"(3) Purchase for the bank's or insured institution's own account, or for the account of any subsidiary of the bank or insured institution, any security of which the securities subsidiary is an underwriter or a member of the selling group until the end of the underwriting period or 90 days after the effective date of the relevant registration statement, whichever is later.

"(4) Issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, to or for the benefit of the investment banking financing company or securities subsidiary.

"(5) Extend credit in any manner to any investment company which is sponsored, organized, controlled, managed or advised by the securities subsidiary.

"(b) CERTAIN FINANCIAL TRANSACTIONS BY INSURED DEPOSITORY INSTITUTIONS FOR THE BENEFIT OF AFFILIATED INVESTMENT BANKING FINANCING COMPANIES OR QUALIFIED SECURITIES SUBSIDIARIES PROHIBITED.--No bank or insured institution controlled by a bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

"(1) Extending credit to an issuer of securities of which the securities subsidiary is an underwriter for the purpose of paying, in whole or in part, the principal of, or any interest or dividends on, those securities.

"(2) Extending credit to a customer of the investment banking financing company or qualified securities subsidiary for the purpose of repaying, in whole or in part, credit extended to such customer by the investment banking financing company or securities subsidiary.

"(c) JOINT PROVISION OF SERVICES OF INSURED DEPOSITORY INSTITUTIONS AND SERVICES OF AFFILIATED INVESTMENT BANKING FINANCING COMPANIES OR QUALIFIED SECURITIES SUBSIDIARIES IN SAME OR RELATED TRANSACTION PROHIBITED.--

"(1) IN GENERAL.--

"(A) No bank or insured institution controlled by a bank holding company may engage, directly or indirectly, in any of the following transactions with respect to any investment banking financing company or securities subsidiary controlled by such bank holding company:

"(i) Extending credit, arranging for the extension of credit, or issuing or entering into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility in connection with any transaction in which the investment banking financing company or securities subsidiary provides services.

"(ii) Extending credit, arranging for the extension of credit, or issuing or entering into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of any person that has obtained services from the investment banking financing company or securities subsidiary within the preceding six months.

"(B) No investment banking financing company or securities subsidiary may engage in any of the following transactions with respect to any affiliated bank or insured institution, or any entity controlled, directly or indirectly, by such bank or insured institution:

"(i) Providing services in connection with any transaction in which the bank or insured institution directly or indirectly extends credit, arranges for the extension of credit, or issues or enters into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility.

"(ii) Providing services to or for the benefit of any person to which the bank or insured institution directly or indirectly has extended credit, arranged for the extension of credit, or issued or entered into a guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility within the preceding six months.

"(2) EXCEPTIONS.--

"(A) The provisions of paragraph (1) shall not apply to any credit or credit instrument or facility provided directly or indirectly by a bank or insured institution, or to services provided directly or indirectly by an investment banking financing company or securities subsidiary, in connection with a transaction consisting exclusively of the securitization of assets consisting of residential mortgage loans or consumer receivables originated by such bank or insured institution or by an affiliated bank or insured institution.

"(B) The provisions of subparagraphs (1)(A)(ii) and (1)(B)(ii) shall not apply with respect to any credit or credit facility or instrument provided by a bank or insured institution prior to the date on which the bank holding company establishes a qualified securities subsidiary.

"(d) CERTAIN FINANCIAL TRANSACTIONS DURING DISTRIBUTION PERIOD FOR CERTAIN NEW ISSUES PROHIBITED.--No bank holding company and no bank, insured institution, or company (other than an investment banking financing company or securities subsidiary) controlled by any bank holding company may, directly or indirectly, extend credit or arrange for the extension of credit to any person, if such credit is secured by, or is used for the purpose of purchasing, any security during the period, and for 30 days after the end of the period, in which such security is the subject of a distribution in which a securities subsidiary of such bank holding company participates as an underwriter or member of the selling group.

"(e) DISCLOSURES OF CONFIDENTIAL CUSTOMER INFORMATION BY INSURED DEPOSITORY INSTITUTIONS TO AFFILIATED INVESTMENT BANKING FINANCING COMPANIES OR SECURITIES SUBSIDIARIES PROHIBITED.--

"(1) IN GENERAL.--No bank or insured institution controlled by a bank holding company may disclose, directly or indirectly, any confidential customer information to any investment banking financing company or securities subsidiary controlled by such bank holding company.

"(2) CONFIDENTIAL CUSTOMER INFORMATION DEFINED.--For purposes of paragraph (1) of this subsection, the term 'confidential customer information' means financial information, including any evaluation of creditworthiness--

Senator DODD. Thank you very much, Dale. Excellent testimony, too, and we appreciate your willingness to be here this morning.

Mr. Goldstein.

STATEMENT OF MR. MICHAEL GOLDSTEIN, SENIOR RESEARCH ANALYST, SANFORD BERNSTEIN AND CO., NEW YORK, NY

Mr. GOLDSTEIN. Thank you for having me here. I'm Michael Goldstein. I'm a senior research analyst and principal of Sanford C. Bernstein and Co. of New York City, which is an investment, research and management firm.

My area of research concentration has been financial services and, in particular, the securities and money management industries.

I'd like to make just three points about the health of the securities industry.

First, the securities industry is inherently quite volatile as its revenues fluctuate with shifts in the capital markets but its costs tend to be fixed in nature.

The broad expansion of the industry over the past two decades has altered the mix of revenues, but has had only a modest impact on this inherent volatility.

Industry employment mirrors this reality. Employment changed by an average of 10 percent a year over the past decade, first rising, then declining. The current downturn in the industry which began well before the crash of 1987 reflects normal cyclical forces compounded by the effects of secularly declining trends, action prices and an over extended expense base.

The industry restructuring now underway is slowly eliminating redundant capacity, reducing fixed cost and gradually improving the quality of the industry's balance sheet. The result of this process will be better operating profitability in the next cyclical recovery.

Second, in general, what happened to the securities industry in the 1980's was that transaction volumes exploded and with them unit pricing concurrently collapsed. Managements then overestimated future gains in volume and overexpanded through internal growth and acquisition.

In the late 1980's, much of the impact of this overexpansion was masked by a historic boom in mergers and acquisitions and high-yield financing. Since that boom ended in late 1989, managements have been forced to address the fundamental economics of the traditional underwriting and customer transaction-oriented business.

The results of this has been a reduction in capacity and flat rather than declining profitability in pricing. The trend should be interpreted as a return to normal rather than a collapse.

Last, in the 1980's, the securities firms began using their capital bases as competitive weapons. This use was seen in the rise of various ill-liquid assets on their balance sheets, including bridge loans, unsold positions in high-yield underwritings, loans to fail limited partnerships and equity investments in leveraged buyouts.

These assets tend to be long-term in nature and subject to wide swings in value.

"(A) concerning or acquired from a customer of a bank or insured institution, or any subsidiary of the bank or insured institution, by reason of a business relationship with the customer of a type which would not, in the ordinary course of business, be divulged to a company of which such bank, insured institution or subsidiary is not an affiliate; or

"(B) obtained through access to the payment system.

Notwithstanding the foregoing, the term "confidential customer information" shall not include any information obtainable from an unaffiliated credit bureau or similar commercially available source.

"(f) PROHIBITION ON RECIPROCAL ARRANGEMENTS.--

"(1) IN GENERAL.--No bank holding company and no bank, insured institution, or company controlled by such bank holding company may enter into any reciprocal arrangement.

"(2) RECIPROCAL ARRANGEMENT DEFINED.--For purposes of this subsection, the term 'reciprocal arrangement' means any agreement, understanding, or other arrangement under which--

"(A) one bank holding company (or any bank, insured institution, or company controlled by such bank holding company) agrees to engage in a transaction with, or on behalf of, another bank holding company (or any bank, insured institution, or company controlled by such other bank holding company), in exchange for

"(B) the agreement of the second bank holding company referred to in subparagraph (A) of this paragraph (or any bank, insured institution, or company controlled by such second bank holding company) to engage in a transaction with, or on behalf of, the first bank holding company referred to in subparagraph (A) (or any bank, insured institution, or company controlled by such first bank holding company),

for the purpose of evading any requirement or prohibition on transactions between, or for the benefit of, affiliates of bank holding companies established under or pursuant to any Federal banking law or regulation.

"(g) INTERLOCKING DIRECTORS AND MANAGEMENT OFFICIALS PROHIBITED.--

"(1) IN GENERAL.--Except as provided in paragraph (2), no bank holding company may allow any director or management official of any investment banking financing company or securities subsidiary controlled by such bank holding company to serve at the same time as a director or management official of any bank or insured institution controlled by such bank holding company or of any subsidiary of any such bank or insured institution.

"(2) EXCEPTION FOR CERTAIN SMALL BANK HOLDING COMPANIES.--

"(A) IN GENERAL.--A bank holding company may allow a director or management official of any investment banking financing company or securities subsidiary controlled by such bank holding company to serve at the same time as a director or management official of a bank or insured institution controlled by such bank holding company, or of any subsidiary of such bank or insured institution, if the total banking assets of such bank holding company do not exceed $500,000,000.

"(B) ANNUAL ADJUSTMENT FOR INFLATION.--The dollar amount of assets referred to in subparagraph (A) shall be adjusted by the Board at the end of each calendar year beginning after December 31, 1990 by the annual percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers published monthly by the Bureau of Labor Statistics.

"(C) MANAGEMENT OFFICIAL DEFINED.--The term "management official" includes any officer and any employee with management functions (including a branch manager), any trustee of a business organization under the control of trustees (such as a mutual savings bank), and any person who has a representative or nominee serving in any of the foregoing capacities.

"(h) APPLICABILITY OF CERTAIN TAXPAYER PROTECTION PROVISIONS TO OTHER SUBSIDIARIES OF BANK HOLDING COMPANY.--

"(1) IN GENERAL.--For purposes of subsections (a), (b) and (c) of this section, any bank holding company that controls an investment banking financing company or qualified securities subsidiary, or any subsidiary of such bank holding company, shall be deemed a bank during any period in which such bank holding company or subsidiary, as the case may be, is an insured depository institution beneficiary.

"(2) INSURED DEPOSITORY INSTITUTION BENEFICIARY DEFINED.--For purposes of this subsection, a bank holding company or subsidiary thereof is an 'insured depository institution beneficiary' if--

"(A) A bank or insured institution controlled by such bank holding company has outstanding credit or an outstanding guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of such bank holding company or subsidiary, as the case may be; or

"(B) An insured depository institution beneficiary (described in subparagraph (A)) controlled by such bank holding company has outstanding credit or an outstanding guaranty, acceptance, letter of credit, endorsement, asset purchase agreement, indemnity, insurance, or other credit instrument or facility to or for the benefit of such bank holding company or subsidiary, as the case may be.

"(3) EXCEPTION FOR CREDIT NOT IN EXCESS OF $1,000,000.--A bank holding company or subsidiary thereof shall not be considered an insured depository institution beneficiary within the meaning of paragraph (2) of this subsection if the outstanding credit or credit facility involved is in an amount not in excess of $1,000,000.

"(4) ANNUAL ADJUSTMENT FOR INFLATION.--The dollar amount of the credit or credit facility referred to in paragraph (3) shall be adjusted by the Board at the end of each calendar year beginning after December 31, 1990 by the annual percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers published monthly by the Bureau of Labor Statistics.

"(i) SHAREHOLDERS IN BANKERS' BANK HOLDING COMPANY, ETC., TREATED AS AFFILIATES OF SECURITIES SUBSIDIARY.--

"(1) IN GENERAL.--In the case of any bank holding company which controls a depository institution described in section 19(b)(1)(A)(vii) of the Federal Reserve Act and a qualified securities subsidiary, any company which owns any interest in or participates in the activities of such bank holding company or depository institution, and any subsidiary of any such company, shall be treated as a bank or insured institution controlled by such bank holding company for purposes of this section (and any provision of sections 12, 13, or 14 of this Act which may be applicable to any proceeding relating to the enforcement of this section).

"(2) EXCEPTION.--Paragraph (1) shall not apply with respect to any bank, and any affiliate of such bank, if the aggregate amount of the interests held by such bank and all affiliates of such bank in a bank holding company or depository institution described in such paragraph do not exceed 5 percent of all interests in such bank holding company or depository institution.

"(j) EXCEPTION FOR INTRA-DAY EXTENSIONS OF CREDIT IN CONNECTION WITH CLEARING GOVERNMENT SECURITIES.--Subsection (a)(1) of this section shall not apply with respect to any extension of credit by any bank or insured institution controlled by a bank holding company, or any subsidiary of any such bank or insured institution, made for the purchase or sale of any securities of the United States or any agency of the United States or any securities on which the principal and interest are fully guaranteed by the United States or any such agency if--

"(1) the extension of credit is to be repaid on the same calendar day;

"(2) the extension of credit is incidental to the clearing of transactions in those securities through such bank, insured institution, or subsidiary; and

"(3) both the principal of and the interest on the extension of credit are fully secured by securities of the United States or any agency of the United States or securities on which the principal and interest are fully guaranteed by the United States or any such agency.".

"(k) PROHIBITIONS ON DISCRIMINATORY CREDIT TREATMENT.--In the case of any bank holding company which controls a qualified securities subsidiary, no bank or insured institution controlled by such bank holding company shall--

"(1) extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated broker or dealer less favorably than such qualified securities subsidiary, unless the extension of credit or denial is based on objective criteria and is consistent with sound business practices; or

97

"(2) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for such qualified securities subsidiary.

"(l) CERTAIN FINANCIAL TRANSACTIONS BETWEEN BANK HOLDING COMPANIES AND AFFILIATED INVESTMENT BANKING FINANCING COMPANIES OR SECURITIES SUBSIDIARIES PROHIBITED.-- No bank holding company may extend credit to, transfer financial assets to, or make an equity investment in any investment banking financing company or securities subsidiary without prior notice to the Board. The Board may prohibit any transaction described in the preceding sentence if it determines that such transaction would affect the financial resources of the bank holding company to such an extent that it would likely impair or diminish significantly the bank holding company's ability to provide financial resources to any bank or insured institution controlled by such bank holding company.

"(m) ADDITIONAL SAFEGUARD PROVISIONS.-- To preserve the safety and soundness of banks and insured institutions controlled by bank holding companies and to ensure that the activities of investment banking financing companies and qualified securities subsidiaries controlled by bank holding companies are conducted without the support of affiliated banks or insured institutions, the Board may promulgate regulations setting forth additional limitations on transactions or other contacts between or among any bank or insured institution controlled by a bank holding company and any investment banking financing company or qualified securities subsidiary controlled by such bank holding company."

SECTION 302. CONSUMER DISCLOSURE REQUIREMENTS.

The Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1841 et seq.), is amended by inserting at the end of section 5 (as added by section 102 of this Act) the following provisions:

"(f) BANK HOLDING COMPANIES WITH SECURITIES SUBSIDIARIES.--Each bank holding company which controls a securities subsidiary shall, in accordance with regulations which the Board shall prescribe, require such subsidiary prominently to disclose in writing to each of such subsidiary's customers, and in any and all advertising of the products or services offered by such securities subsidiary, that--

"(1) the securities subsidiary--

"(A) is not a federally insured bank or insured institution; and

"(B) is a separate corporate entity with respect to any bank or insured institution affiliate of such subsidiary; and

"(2) securities underwritten, sold, offered, or recommended by the securities subsidiary--

"(A) are not deposit instruments which are federally insured;

"(B) are not instruments which are guaranteed either as to principal or interest by a bank or insured institution affiliate of such subsidiary; and

"(C) are not otherwise obligations of any bank or insured institution.

"(g) DEPOSITORY INSTITUTIONS.--No bank or insured institution controlled by a bank holding company, and no subsidiary of such bank or insured institution, shall offer to any customer or in connection with any advertisement an opinion on the value of, or the advisability of purchasing or selling, any security of which a securities subsidiary of such bank holding company is an underwriter or which such securities subsidiary sells, or offers for sale, unless such bank, insured institution, or subsidiary prominently discloses to the customer in writing, or prominently discloses in the advertisement, as the case may be, and in accordance with such requirements as the Board may by regulation prescribe, that--

"(1) the securities subsidiary is an affiliate of such bank, insured institution, or subsidiary;

"(2) the securities subsidiary--

"(A) is not a bank or insured institution; and

"(B) is a separate corporate entity with respect to any bank or insured institution (or any subsidiary of such bank or insured institution) which is an affiliate of such securities subsidiary; and

"(3) the securities underwritten, sold, offered, or recommended by the securities subsidiary--

"(A) are not deposit instruments which are federally insured;

"(B) are not instruments which are guaranteed either as to principal or interest by a bank or insured institution affiliate of such subsidiary; and

"(C) are not otherwise obligations of any bank or insured institution."

SECTION 303. ADMINISTRATIVE ENFORCEMENT AND PENALTIES FOR VIOLATIONS.

(a) IN GENERAL.--Section 12 of the Bank Holding Company Act of 1956, as amended and as redesignated by section 2 of this Act, is amended by adding at the end of subsection (b)(1) thereof the following provision:

"Notwithstanding the preceding sentence, any bank holding company or any bank, insured institution, or company controlled by a bank holding company which violates any provision of section 8 of this Act or any regulation prescribed by or order issued by the Board pursuant thereto shall forfeit and pay a civil penalty of not more than--

"(A) $100,000 for each such violation and

"(B) an additional $10,000 for each day the violation continues,

except that in no case shall any such amount for any violation or related series of violations exceed 1 percent of the minimum required capital of the bank holding company, bank, insured institution, or company involved; and any officer, director, employee, or other person participating in the conduct of the affairs of any bank holding company or any bank, insured institution, or company controlled by a bank holding company who violates any provision of section 8 of this Act or any regulation prescribed by or order issued by the Board pursuant thereto shall forfeit and pay a civil penalty of not more than $50,000 for each such violation and an additional $5,000 for each day such violation continues."

(b) DIVESTITURE UNDER CERTAIN CIRCUMSTANCES.--Section 9 of the Bank Holding Company Act of 1956, as amended and as redesignated by section 2 of this Act, is amended by inserting at the end thereof the following new subsection:

"(g) SPECIAL RULE FOR DIVESTITURE OF BANK SUBSIDIARIES FOR CONTINUING COURSE OF MISCONDUCT WITH SECURITIES SUBSIDIARY.

"(1) NOTICE OF PRELIMINARY DETERMINATION.--

"(A) PRELIMINARY FINDING.--In addition to any other regulatory and supervisory authority of the Board, if the Board has reason to believe that a bank holding company which controls a qualified securities subsidiary, or any subsidiary of such bank holding company, has engaged in a willful or continuing course of conduct involving one or more violations of sections 5 or 8 of this Act, or of any regulation prescribed by the Board pursuant to either such section, and that, by reason of such course of conduct, (i) any bank or insured institution has suffered or probably will suffer significant financial loss or other damage, or (ii) the interests of the bank's or the insured institution's depositors have been or are likely to be prejudiced, the Board may make an initial determination that the bank holding company shall be required to divest control of any bank or insured institution or any subsidiary of such bank or insured institution.

"(B) NOTICE.--The Board shall notify any bank holding company with respect to which a preliminary determination is made under subparagraph (A) of such determination before the end of the 3-day period beginning on the date on which the determination is made.

"(C) CONTENTS OF NOTICE.--Any notice under subparagraph (B) shall contain a statement of the basis for the Board's determination.

"(2) HEARING AND FINAL ORDER.--

"(A) REQUEST FOR HEARING.--Any bank holding company which receives a notice under subparagraph (1)(B) of this subsection may request, at any time before the end of the 30-day period beginning on the date of the receipt of such notice, a hearing before the Board.

"(B) ADJUDICATORY PROCEDURE AND FINAL ORDER.--If, on the basis of the evidence presented at a hearing before the Board (or any person designated by the Board for such purpose), in which all issues shall be determined on the record in accordance with section 554 of Title 5, United States Code, and the written findings of the Board (or such person) with respect to such evidence (which shall be conclusive), the Board finds that the conduct or practices which gave rise to the preliminary determination and which were specified in the notice issued under subparagraph (1)(B) of this subsection has been established, the Board may, after consultation with the appropriate Federal regulatory agency (as defined in section 3(q) of the Federal Deposit Insurance Act of 1950, as amended) as necessary for the protection of depositors (if any), issue an order requiring the bank holding company to divest control of the bank, insured institution, or subsidiary, as the case may be. Such order shall become final and effective at the time specified therein, which shall in no event be less than 30 days from the date of service thereof upon such bank holding company.

"(3)FAILURE TO CONTEST.--Any bank holding company which receives a notice under subparagraph (1)(B) of this subsection and either fails to request an agency hearing within the time period provided under subparagraph (2)(A) of this subsection or fails to appear at the hearing by a duly authorized representative shall be deemed to have consented to the issuance of a final order affirming the initial determination without the necessity of the hearing provided for in this subsection.

"(4) JUDICIAL REVIEW.--Any bank holding company which has been served with an divestiture order under this subsection (other than a divestiture order by consent) shall have the right of judicial review of such order only to the same extent as provided for the review of orders under section 8(h) of the Federal Deposit Insurance Act of 1950, as amended.

"(5) DIVESTMENT WITHIN TIME SPECIFIED IN ORDER.--If any order issued by the Board under this subsection becomes final and the order affirms the initial determination, the bank holding company shall terminate such company's control of the bank or insured institution, or the subsidiary of such bank or insured institution, specified in such order by the end of the period specified in the order. The Board shall publish notice of such divestiture order and the bank holding company shall cause notice thereof to be sent to each of the depositors (if any) of the institution to be divested at his last address of record on the books of such institution, in such manner and at such time as the Board may find to be necessary and may order for the protection of depositors."

SECTION 304. APPLICATION OF FEDERAL DEPOSIT INSURANCE COVERAGE.

Section 13 of the Federal Deposit Insurance Act of 1950, as amended (12 U.S.C. § 1823), is amended by inserting at the end thereof the following new subsection:

"(l) APPLICATION OF FEDERAL DEPOSIT INSURANCE COVERAGE.--In no instance shall the benefits of Federal deposit insurance coverage applicable to an insured depository institution be extended by the Corporation to any affiliate thereof that is not an insured depository institution. The purpose of this subsection is to prevent the resources of the Federal deposit insurance funds from being used to protect the shareholders or business interests of a holding company that controls an insured depository institution or of its affiliates that are not insured depository institutions, except through the authorized fulfillment of the Federal deposit insurance funds' obligations to protect the insured deposits of an insured depository institution."

SECTION 305. REGULATIONS.

(1) IMPLEMENTATION REPORT TO CONGRESS.--The Board of Governors of the Federal Reserve System shall submit a report to Congress containing proposed regulations required to implement the amendments made by this title to the Bank Holding Company Act of 1956, as amended, including regulations

required to be prescribed jointly by the appropriate Federal depository institution regulatory agencies, before the end of the 90-day period beginning on the date of the enactment of this title.

(2) FINAL REGULATIONS.--The final regulations required to implement the amendments made by this subtitle, including regulations required to be prescribed jointly by the appropriate Federal depository institution regulatory agencies, shall be prescribed and published before the end of the 150-day period beginning on the date of the enactment of this Act.

TITLE IV – SECURITIES REGULATION OF SECURITIES ACTIVITIES OF DEPOSITORY INSTITUTIONS

Subtitle A - Broker-Dealer Provisions

SECTION 401. DEFINITION OF BROKER.

Section 3(a)(4) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78c(a)(4)), is amended to read as follows:

"(4)(A) The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others.

"(B) A bank shall not be deemed to be a 'broker' because it engages in one or more of the following activities:

"(i) engaging in trust activities (including effecting transactions in the course of such trust activities) permissible for national banks under the first section of the Act of September 28, 1962 (12 U.S.C. 92a) or for State banks under relevant State trust statutes or law unless the Bank--

"(I) publicly solicits brokerage business other than by advertising, in conjunction with advertising its other trust activities, that it effects transactions in securities, or

"(II) is compensated for such business by the payment of commissions or similar remuneration based on effecting transactions in securities (excluding fees calculated as percentage of assets under management) in excess of the bank's incremental costs directly attributable to effecting such transactions; except that this clause does not apply to securities safekeeping, self-directed individual retirement accounts, or managed agency or other functionally equivalent accounts of a bank;

"(ii) effecting transactions in exempted securities, other than municipal securities, or in commercial paper, bankers' acceptances, or commercial bills; and

"(iii) effecting transactions in municipal securities, if the bank is not an affiliate of a qualified securities subsidiary as defined in section 2(n) of the Bank Holding Company Act of 1956, as amended."

SECTION 402. DEFINITION OF DEALER.

Section 3(a)(5) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78c(a)(5)), is amended to read as follows:

"(5)(A) The term 'dealer' means any person engaged in the business of buying and selling securities for his own account through a broker or otherwise.

"(B) Such term does not include--

"(i) any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business; or

"(ii) any bank insofar as the bank (I) buys and sells commercial paper, bankers' acceptances, commercial bills, or exempted securities other than municipal securities; (II) buys

99

and sells municipal securities and is not an affiliate of a qualified securities subsidiary as defined in section 2(n) of the Bank Holding Company Act of 1956, as amended; or (III) buys and sells securities for investment purposes in the course of trust activities.".

SECTION 403. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER.

Section 3 of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78c), is amended by adding at the end the following:

"(e) The Commission, by rule, regulation, or order, upon its own motion or upon application, may conditionally or unconditionally exempt any person or class of persons from the definitions of 'broker' or 'dealer' if the Commission finds that such exemption is consistent with the public interest, the protection of investors, or the purposes of this title."

SECTION 404. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY.

Section 15(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78o(a)), is amended to read as follows:

"SEC. 15. (a)(1) It shall be unlawful for any broker or dealer that is either a person other than a natural person or a natural person not associated with a broker or dealer that is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

"(2) It shall be unlawful for any bank to act as a broker or dealer, except in the course of an exclusively intrastate business. This section shall not preclude a subsidiary of a bank or an affiliate of a bank holding company other than a bank, as those terms are defined in the Bank Holding Company Act of 1956, as amended, that is registered in accordance with subsection (b) of this section from acting as a broker or dealer to any extent otherwise permissible by law.

"(3) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraphs (1) and (2) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.".

Subtitle B - Emergency Credit During Generalized Liquidity Crisis

SECTION 411. ACCESS TO FEDERAL RESERVE BY CERTAIN INSTITUTIONS.

Section 13, para. 13 of the Federal Reserve Act (12 U.S.C. § 347c) is amended by inserting "(1)" at the beginning thereof and by inserting the following new subsection at the end thereof:

"(2) Whereas it is the intent of Congress to ensure that advances described in subsection (1) of this section are available to certain financial institutions in times of generalized liquidity crises when short-term credit may not otherwise be available to such financial institutions, the following procedures shall apply to requests for advances by such institutions in such circumstances. Upon receipt by the Board of Governors of the Federal Reserve System of notice from the Securities and Exchange Commission (which notice may be transmitted by facsimile equipment or by telephone, with written confirmation of such notice as soon as is practicable) to the effect that on the date of such notice there is a generalized liquidity crisis affecting brokers (as defined in section 3(a)(4) of the Securities Exchange

Act of 1934, as amended) and dealers (as defined in section 3(a)(5) of the Securities Exchange Act of 1934, as amended), such advances may be made upon the request of any broker or dealer (which request may be transmitted by facsimile equipment or by telephone, with written confirmation of such notice as soon as is practicable) in the amounts specified in such request by such broker or dealer, provided that such broker or dealer (i) certifies in such request that the amount of such requested advance does not exceed the amount needed by such broker or dealer on such date as a result of a generalized liquidity crisis, and (ii) attaches to such certification written confirmation from the Securities and Exchange Commission that (A) as of the latest date for which such information is available, the broker or dealer was in compliance with the Securities and Exchange Commission's capital requirements and (B) the Securities and Exchange Commission has no reason to believe that, as of the date of such request, the broker or dealer is not in compliance with the Securities and Exchange Commission's capital requirements. The provisions of the preceding sentence shall apply only on the date or dates on which the Board of Governors of the Federal Reserve System receives such certification and confirmation from the Securities and Exchange Commission. The Securities and Exchange Commission shall provide in a timely fashion any reports in its possession concerning compliance by a broker or dealer with the Commission's capital requirements to the Board of Governors of the Federal Reserve System in response to an inquiry from the Board in connection with a request by a broker or dealer for an advance pursuant to this subsection. If an advance is made to a broker or dealer and the Board of Governors of the Federal Reserve System subsequently determines that such certification by such broker or dealer was made in bad faith, such broker or dealer shall be precluded from receiving additional advances under this section for a period of three years beginning on the date of such certification. The provisions of this subsection shall apply to any investment banking financing company (as defined in section 2(o) of the Bank Holding Company Act of 1956, as amended) as if it were a broker or dealer."

TITLE V – NATIONAL ELECTRONIC PAYMENTS CORPORATION.

SECTION 501. SHORT TITLE.

This title may be cited as the "National Electronic Payments Corporation Act of 1991."

SECTION 502. PURPOSE.

It is the purpose of this title to establish a National Electronic Payments Corporation -

(1) to muster the equity investment needed to upgrade materially and streamline the crucial operational systems and backup systems needed to enhance the reliability and integrity of the large-dollar electronic payments system;

(2) to achieve a major step forward in providing finality of payments;

(3) to augment the cash and liquidity balances associated with the operation of the system;

(4) to provide a vehicle through which public and private institutions can work together in securing a safer and more efficient payments mechanism;

(5) to provide equal access to the system to all large users thereof; and

(6) to establish a vehicle which can materially reduce the susceptibility of the payments systems to shocks whether they are operational, liquidity-related, or credit-related in nature.

SECTION 503. DEFINITIONS.

For the purpose of this title:

(1) CORPORATION. - The term "Corporation" means the National Electronic Payments Corporation established by this title.

(2) BOARD OF DIRECTORS. - The term "Board of Directors" means the Board of Directors of the Corporation.

(3) BOARD OF GOVERNORS - The term "Board of Governors" means the Board of Governors of the Federal Reserve System.

(4) PRIVATE SHAREHOLDER - The term "private shareholder" means any depository institution, bank holding company, broker, dealer, or other company which the Board of Directors determines has a sufficient level of large dollar transactions to require, or make appropriate, access to the national electronic payments system of the Corporation.

SECTION 504. ESTABLISHMENT OF THE CORPORATION.

(a) ESTABLISHMENT.--There is established the "National Electronic Payments Corporation", which shall be a body corporate and shall be under the direction of a Board of Directors consisting of 4 members selected by the Board of Governors and 3 members selected by the private shareholders. The principal office of the Corporation shall be in the District of Columbia or at such other place as the Corporation may prescribe.

(b) POWERS.--The Corporation is authorized -

(1) to adopt, alter, and use a corporate seal;

(2) to have succession until dissolved by Act of Congress;

(3) to make and enforce such bylaws, rules, and regulations as may be necessary or appropriate to carry out the purposes or provisions of this title;

(4) to make and perform contracts, agreements, and commitments;

(5) to prescribe and impose fees and charges for services by the Corporation;

(6) to settle, adjust, and compromise, and with or without consideration or benefit to the Corporation to release or waive, in whole or in part, in advance or otherwise, any claim, demand, or right of, by, or against the Corporation;

(7) to sue and be sued, complain, and defend, in any State, Federal, or other court;

(8) to acquire, take, hold, and own, and to deal with and dispose of any property;

(9) to determine its necessary expenditures and the manner in which the same shall be incurred, allowed, and paid, and appoint, employ, and fix and provide for the compensation and benefits of officers, employees, attorneys, and agents, all without regard to any other law. Nothing in this title or any other law shall be construed to prevent the appointment, employment, and provision for compensation and benefits, as an officer, employee, attorney, or agent of the Corporation, of any officer, employee, attorney, or agent of any department, establishment, or corporate or other instrumentality of the United States Government; and

(10) with the consent of any department, establishment, agency, or instrumentality of the United States Government, to utilize and act through any such department, establishment, agency, or instrumentality and avail itself of the use of information, services, facilities, and personnel thereof, and to pay compensation therefor.

(c) COOPERATION.--Every department, establishment, agency, and instrumentality of the United States Government is authorized to provide to the Corporation such information, services, facilities, and personnel as the Corporation may request, provided that the Corporation shall pay therefor such compensation as the Comptroller General determines to be reasonable for the provision of the same or similar information, services, facilities, or personnel by any such department, establishment, agency, or instrumentality to a Government Corporation.

(d) INVESTMENTS.--Funds of the Corporation may be invested as the Board of Directors may prescribe. Any Federal Reserve Bank or any bank as to which, at the time of its designation by the Corporation, there is outstanding a designation by the Secretary of the Treasury that such bank is a general or other depositary of public money, may be designated by the Corporation as a depositary or custodian or as a fiscal or other agent of the Corporation, and is hereby authorized to act as such depositary, custodian, or agent. When designated for that purpose by the Secretary of the Treasury, the Corporation shall be a depositary of public money, under such regulations as may be prescribed by the Secretary of the Treasury, and may also be employed as fiscal or other agent of the United States, and it shall perform all such reasonable and customary duties as such depositary or agent as may be required of it.

(c) JURISDICTION OF COURTS.--Notwithstanding section 1349 of title 28, United States Code, or any other provision of law, (1) the Corporation shall be deemed to be an agency included in sections 1345 and 1442 of such title 28; (2) all civil actions to which the Corporation is a party shall be deemed to arise under the laws of the United States, and the district courts of the United States shall have original jurisdiction of all such actions, without regard to amount or value; and (3) any civil or other action, case or controversy in a court of a State, or in any court other than a district court of the United States, to which the Corporation is a party may at any time before the trial thereof be removed by the Corporation, without the giving of any bond or security, to the district court of the United States for the district and division embracing the place where the same is pending, or, if there is no such district court, to the district court of the United States for the district in which the principal office of the Corporation is located, by following any procedure for removal of causes in effect at the time of such removal. No attachment or execution shall be issued against the Corporation or any of its property before final judgment in any State, Federal, or other court.

SECTION 505. DUTIES OF THE CORPORATION.

(a) IN GENERAL.--Subject to policies prescribed by the Board of Directors, the Corporation shall --

(1) establish, operate, and maintain a national electronic payments system to facilitate large dollar transactions, such as funds transfers and transfers of book entry United States Government securities, drawn on accounts at Federal Reserve banks;

(2) promulgate and enforce policies governing standards for utilization of the national electronic payments system, including requirements for the maintenance of liquidity reserve balances in Federal Reserve banks, including a stock subscription requirement;

(3) provide for the development or improvement of telecommunications facilities to operate the national electronic payments system, with appropriate levels of backup and bypass facilities to assure operational reliability of the system;

(4) prescribe procedures relating to the operation of the national electronic payments system, including procedures to enforce compliance with orders of the Board of Governors relating to intraday overdrafts; and

(5) take such other actions as may be necessary to carry out the purposes of this title.

(b) FINALITY OF PAYMENTS.--All payments made through the national electronic payments system shall be final and irrevocable upon receipt.

SECTION 506. CAPITALIZATION.

(a) CAPITAL CONTRIBUTIONS.--The authorized equity capital of the Corporation shall be $900,000,000, of which -

(1) an amount not less than $450,000,000 and not more than $500,000,000 shall be paid in by the Federal Reserve System; and

(2) the balance shall be paid in by private shareholders.

The Board of Directors shall provide for the issuance of stock certificates evidencing ownership of the Corporation.

(b) DIVIDENDS.--The Corporation may from time to time pay dividends to its shareholders. The dividend rate shall be established from time to time by the Board of Directors, taking into account the need to retain sufficient earnings to assure continuing research and development on payment system technology and the establishment and maintenance of an adequate level of capital.

SECTION 507. ACCESS TO THE SYSTEM.

(a) IN GENERAL.--The Board of Directors shall establish a list of banking and other financial organizations which have transactions in funds and government securities of a sufficient magnitude to make their participation as shareholders in the Corporation appropriate. In establishing such list, the Board of

Directors shall not discriminate among organizations on the basis of whether or not such organizations are banking organizations. After establishing such list, the Board of Directors shall invite the participation of those organizations as shareholders in the Corporation. In order to encourage membership, the Board of Directors may, but is not required to, limit access to the payment system to only those organizations which are shareholders.

(b) FEES.--The Board of Directors shall establish and may adjust from time to time a schedule of fees for use of the Corporation's facilities. The initial schedule and any modification thereto shall be subject to approval by the Board of Governors.

SECTION 508. REPORTS TO CONGRESS.

The Corporation shall transmit to the Congress not later than November 1 of each year a report on its activities during the preceding fiscal year.

SECTION 509. AUTHORIZATION OF APPROPRIATIONS.

There are authorized to be appropriated such sums as are necessary to finance the organization costs of the Corporation.

SECTION 510. TRANSITIONAL ACCESS TO FEDWIRE SYSTEM FOR CERTAIN FINANCIAL INSTITUTIONS.

(a) During the period beginning 180 days after the effective date of this Act and terminating on the date the national electronic payments system to be established pursuant to Section 605 of this Act is operational, qualified financial organizations shall be permitted direct access to the Fedwire electronic payments system maintained by the Board of Governors.

(b) Prior to the date that is 180 days after the effective date of this Act, the Board of Governors shall revise its regulations and promulgate such additional regulations as are necessary or appropriate (i) to establish participation standards for operational and backup systems of qualified financial organizations, (ii) to provide for direct access by qualified financial organizations to the Fedwire electronic payments system, and (iii) to provide that all payments made through the Fedwire electronic payments system shall be final and irrevocable upon receipt. The participation standards established by the Board of Governors pursuant to clause (i) of the preceding sentence shall not discriminate among qualified financial organizations and bank participants in the Fedwire electronic payments system.

(c) For purposes of this section, the term "qualified financial organization" shall mean any broker-dealer (as defined in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, as amended) or investment banking financing company (as defined in section 2(o) of the Bank Holding Company Act of 1956, as amended) that has been determined by the Board of Governors to have operational and backup systems for participation in the Fedwire electronic payments system that meet the participation standards promulgated by the Board of Governors pursuant to subsection (b).

SECTION 5. EFFECTIVE DATE.

This Act shall be effective upon the date of enactment.

Furthermore, a large increase in owned and occupied real estate, which, unfortunately, occurred at or near the peak of the commercial real estate cycle further reduced the industry's inherent capital flexibility. The cost of writing down these ill-liquid investments in owned real estate to realizable values has amounted to between $1-2 billion in the last year alone. Most of the lost capital was replaced by infusions from the corporate parents from outside the industry.

These charges have greatly depressed current earnings but have improved the quality of both the assets and the stated equity capital.

Based upon public disclosures, most, but not all, of the needed charges have been taken and the industry's capital base today appears adequate, but not excessive.

In conclusion, the industry is restructuring itself in response to both cyclical forces and longstanding over-capacity. Its financial health has probably ceased eroding and the prospects for improved profitability appear reasonable.

Thank you for giving me the opportunity to express my views.

[The complete prepared statement of Michael L. Goldstein follows:]

MATERIAL SUBMITTED BY THE SECURITIES INDUSTRY ASSOCIATION

FOREIGN

Foreign Transactions in U.S. Securities 1
Foreign Net Purchases of U.S. Equities 2
Investor Demand for U.S. Equities 3
Foreign Net Purchass of U.S. Treasury Bonds and Notes 4
Foreign Interest in U.S. Public Debt is on the Wane 5
U.S. Net Purchases of Foreign Equities 6
U.S. Net Purchases of Foreign Bonds 7
Net Portfolio Investment in the U.S. 8

SECURITIES INDUSTRY

Pre-Tax Return on Equity: Securities Industry vs. All Manufacturing Corps. 9
Securities Industry Pre-Tax Profit Margin 10
Securities Industry Pre-Tax ROE by Type of Firm 11
Profits: Large Investment Banks vs All Other Firms 12
NYSE Member Firms Unprofitable 13
Shrinking Employment Since the Crash 14
Holdings of U.S. Equities 15
Securities Industry Revenue Growth 16
Commissions Share of Industry Revenues 17

CAPITAL MARKETS

Mergers & Acquisitions 18
Junk Bonds Underwritten 19
Municipal Bond Underwritings 20
New Equity Issuance 21
"True" IPOs Have Crashed Since the Crash 22
Banks vs. Brokers 23

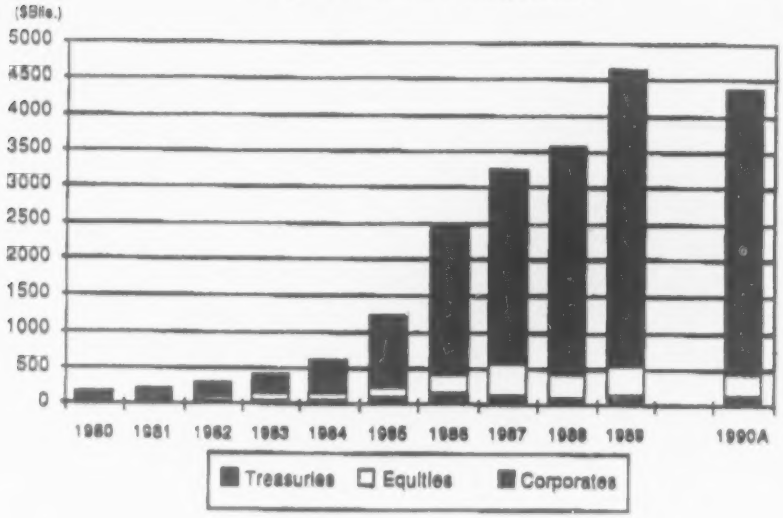
Prepared by SIA Research Department

FOREIGN INVESTMENT ACTIVITY

THIS SECTION DETAILS FOREIGN PARTICIPATION IN THE U.S. EQUITY AND BOND MARKETS AND U.S. ACTIVITY IN FOREIGN SECURITIES MARKETS.

1

Foreign Transactions in U.S. Securities



Key Numbers

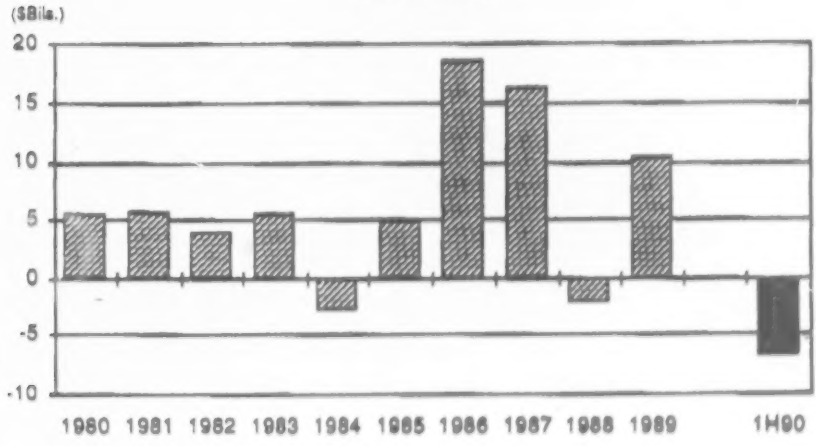
- Foreign transactions in U.S. securities grew in every year of the 1980s, increasing from under $500 billion in 1980 to over $4.5 trillion in 1989.
- Foreign transactions subsided from the 1989 peak in 1990 but will still be above any other year.

Insights

- Dramatic increase in activity due to technology, investor diversification, market liberalization, and capital imbalances.
- Increase in activity helps explain expansion of financial intermediaries into foreign markets.

2

Foreign Net Purchases Of U.S. Equities



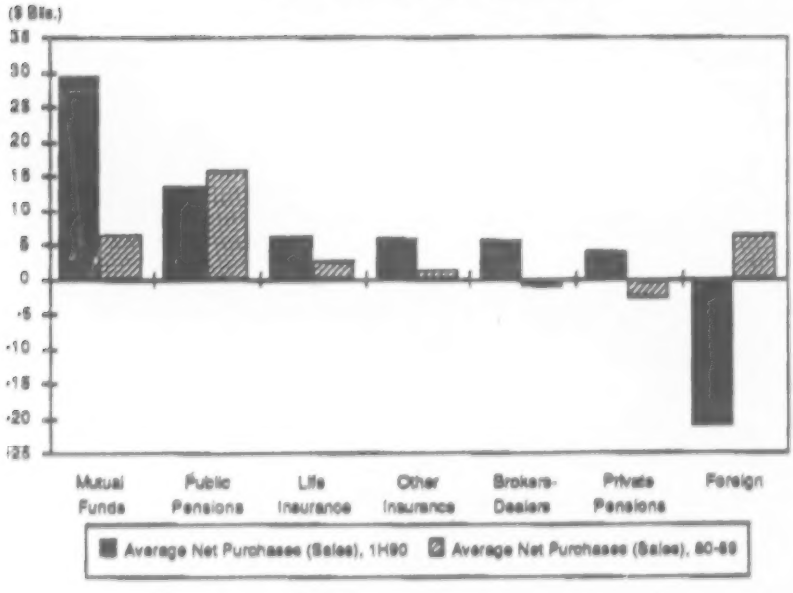
Key Numbers

- Foreign net purchases of U.S. equities reached a record in 1986 of almost $19 billion and the 1987 level was over $16 billion.
- While foreign investors were relatively modest net sellers of U.S. equities in 1984 and 1988, in the first half of 1990 these investors sold well over $6 billion of equities.

Insights

- Record levels in 1986 spurred by 23% increase in the DJIA; 1987 level strongly impacted by October Crash.
- 1990 net sales induced by slow U.S. economy, better performing foreign markets and "new" non-U.S. markets.

Investor Demand for U.S. Equities



Key Numbers

- During the 1980-89 period, public pension funds were the largest net purchasers of equities. Public pension funds are those that mainly manage the pension monies of government employees. Foreign investors were the second largest institutional purchaser.

- In the first half of 1990, foreign investors were the only net sellers of equities, with net sales of over $20 billion made on an annualized basis.

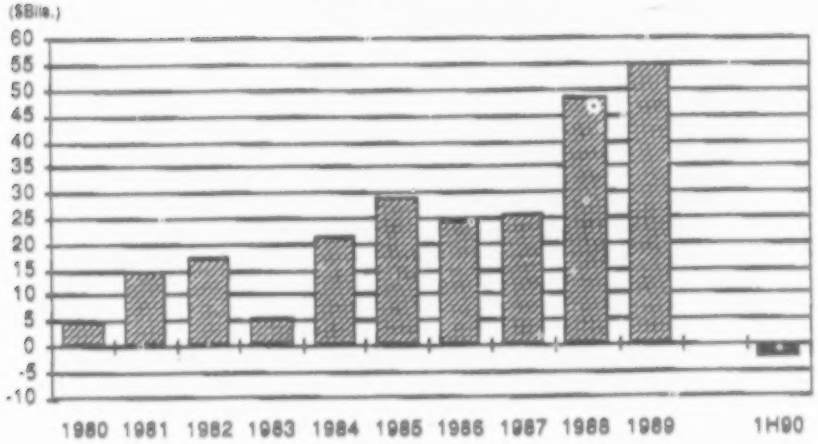
Insights

- Foreign investors were the second largest net purchasers of U.S. equities in the 1980s.

- Foreign investors hold just under 7% of U.S. equities outstanding.

4

Foreign Net Purchases Of U.S. Treasury Bonds And Notes



Key Numbers

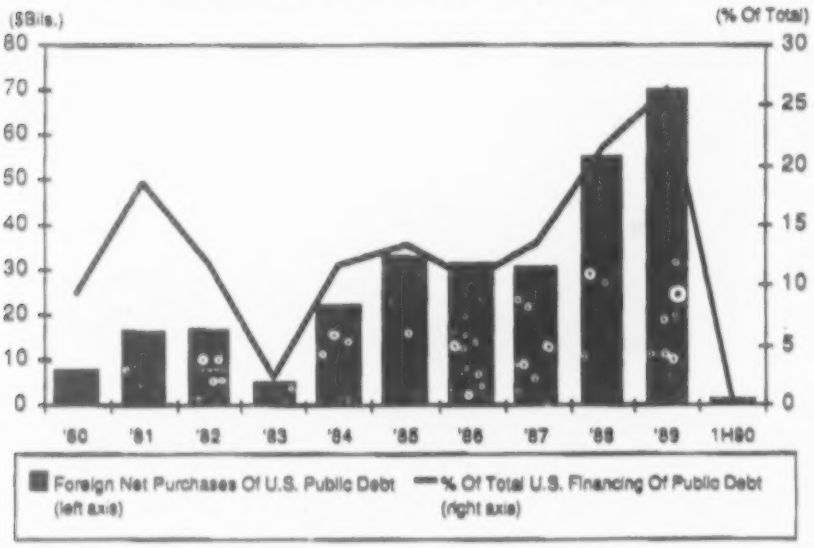
- Foreign net purchases of U.S. Treasury Bonds and Notes escalated from about $5 billion in 1980 to $55 billion in 1989.
- Japanese investors were the major buyers of Treasuries in the 1980s.
- In the first half of 1990, foreign investors were net sellers of Treasuries.

Insights

- Foreign investors were an important source of capital in the 1980s.
- 1990 trend influenced by U.S. inflation, declining dollar and better yields overseas.

5

Foreign Interest In U.S. Public Debt Is On The Wane



Key Numbers

- As the 1980s progressed, foreign capital played a larger role in financing the U.S. deficit.
- In 1980-87, foreign investors helped finance about 14% annually of net public debt. In 1988-89, that financing jumped to about 25%.

Insights

- Foreign investors hold about 20% of privately held U.S. Treasury bonds and notes.
- Lack of interest in 1990 is a negative for U.S. interest rates.

Committee on Banking, Housing and Urban Affairs

Subcommittee on Securities
United States Senate

Hearing on the Condition of the Securities Industry
January 8, 1991

Testimony of

Michael L. Goldstein
Senior Research Analyst
Sanford C. Bernstein & Co., Inc.

TESTIMONY

I would like to thank the Subcommittee for the opportunity to participate in its hearings on the condition of the securities industry. I am Michael Goldstein, a research analyst and principal of Sanford C. Bernstein & Co., Inc., an investment research and management firm headquartered in New York City. My area of research concentration has been financial services, and in particular, the securities and money management industries. I will offer my views on the state of the industry, its financial health, and regulation.

State of the Securities Industry

The securities industry is extremely dynamic in character owing primarily to the inherent unpredictability of the capital markets. Over the past fifteen years the industry has been in a state of continual change. The stocks of the securities companies are among the most volatile in the equity market and in fact, they are 40% more volatile than the market itself. Over the past decade industry employment has changed by an average of 10% per year, first increasing and then declining. It is not surprising then, that the present adverse economic and capital market environment has brought further change and hastened the industry's evolution. I believe the current restructuring trend will ultimately bolster profitability and improve efficiency, and should be viewed as constructive to the industry's long-term prospects.

The current downturn, which began well before the crash in early 1987, reflects normal cyclical forces compounded by the effects of secularly declining transaction pricing and an overextended cost structure. Most of the major changes of the past decade -- the rise of the institutional investor, the deregulation of foreign securities markets, the securitization of mortgage and loan markets, the advent of rule 415 underwritings, and the creation of the derivative markets -- have had the effect of continuously reducing real pricing.

The institutional equity business provides a case study of these effects. In the boom phase of the current cycle (the years 1979-1987) turnover of stocks by institutions increased two and one-half-fold and the per-share cost of this activity declined by 40%. Rising volume largely offset, and in fact spurred, falling prices. Since 1987, turnover has fallen by a third and pricing has also continued to erode, declining by an additional 10%. The negative pricing dynamic has persisted because the customer base is concentrated -- the largest 5% of institutions account for nearly half of all revenues -- and because too many securities firms offer perceived similar services. Despite the fact that the industry has been in a downturn for nearly four years, capacity still exceeds "normal" demand. The primary reason this overcapacity has persisted for so long is that the institutional equity business was subsidized by the mergers and acquisitions/high yield boom of the late 1980s. Since that boom ended a year ago, capacity has started to decline and the pricing trend has flattened. The industry is now addressing the true economics of the business. This process is now underway across most of the industry's lines of business.

A second major factor exacerbating the current cyclical downturn is an overextended cost base. In the 1980s most large securities firm expanded based on the principal of "full service." To be strong

competitors, these organizations believed they had to offer services to meet every conceivable demand of their customers. These demands were thought to include real estate limited partnerships, first and second mortgage loans, bridge loans, foreign securities and direct equity investments. Several ill-advised acquisitions were made under the dual theories of full-service and economies of scale.

The overextended cost base has proved difficult to reduce because some of it involved long-term commitments in the form of real estate leases, illiquid bridge loans,and contractual commitments to employees. Nonetheless, the bulk of the industry's cost is the variable compensation of employees and, along with staff reductions, compensation levels are declining. Ultimately, some further consolidation of both national and regional firms may occur to further rationalize the cost structure.

The industry's fortunes will also likely be aided by cyclical forces. I believe current activity levels are much closer to their trough than their peak, and that a cyclical upturn is quite likely off today's base of activity. The peak-to-trough percentage declines shown below are quite similar to those seen at the trough of previous downturns.

	Market Turnover Rates			As a % of all Equities	
	Equity Trading	Govt. Debt Trading	Average Retail Production Per Rep ($000s)	Corp. Equity Under-writings	M & A
1975-1990 Average	45%	503%	$174	1.0%	4.5%
Peak Level	73	689	247	2.2	8.4
Current	46	582	185	0.4	4.7
% Change	-37%	-25%	-25%	-82%	-44%

In particular the prospects for a major equity underwriting cycle appear very good at this juncture. In real terms the issuance of new equity in 1990 was at its lowest level since the late 1960s, while corporate leverage is at all-time peak levels. The current economic downcycle has pressured many highly-leveraged companies and increased their need for equity capital. I can foresee a three-to-five-fold increase in equity raising in a rising equity market.

Financial Health of the Industry

The securities industry's assets are, in general, liquid securities which are held for short durations. Typically, the trading inventories of large securities firms turn over every eight-to-ten days. As a result the industry has not typically had the type of asset quality problems seen most notably in the thrift industry. In the 1980s the industry's financial health eroded as the liquidity of assets held declined, in ways both anticipated and unanticipated. Owned and occupied real estate (primarily in New York), bridge loans, unsold high-yield bond underwritings, and loans to failed limited partnerships all eroded credit quality. In 1989 and 1990, much of this erosion was addressed, as unoccupied real estate was relet at a loss and bad loans and investments were written down to realizable levels. The capital infusions

needed to replace the lost capital were in most cases provided by corporate parents from outside the securities industry. The quality of the industry's assets is on the rise and most, but not all, credit problems have been addressed.

It is not at all clear that large amounts of capital are generally the key to competitiveness. In fact, some of the most highly capitalized of the industry's participants have been among the least profitable. The keys to success appear to be fostering service quality, willingness to take risk and the capability to manage it, technical expertise, and corporate culture, not the magnitude of capital.

The second element of financial health is current profitability. Profitability in recent quarters has been depressed by adverse financial markets and the costs associated with restructuring both the size of operations and balance sheets. These efforts have improved the fundamental economics of the business, though, and profitability should improve dramatically when any upturn occurs.

Regulation of the Industry

I do not consider myself to be an expert on the regulation of the securities industry, but I do have several observations. First, the concept of regulating financial intermediaries by business function seems appropriate. Today, the same activity performed in different organizations can be regulated differently, or not at all. In the last decade the traditional differences between intermediaries have nearly disappeared.

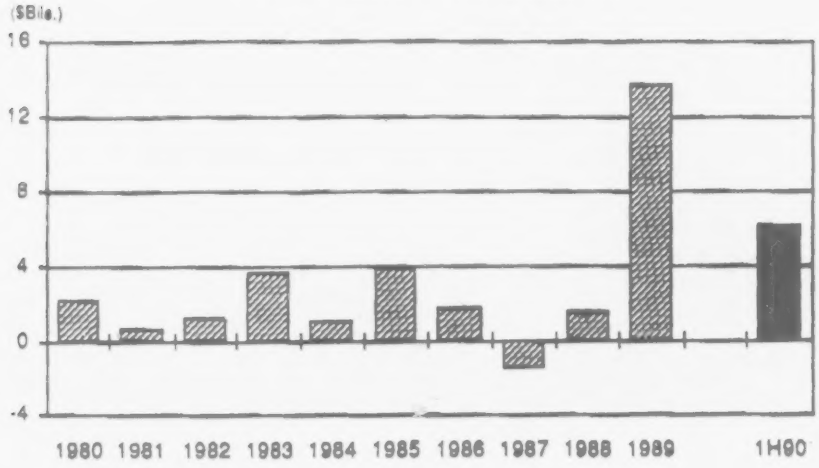
Related to functional regulation is the concept of affiliation. In the long run, allowing commercial banks and brokerage firms to operate under a single corporate umbrella will further efficiency, particularly in the sector of the industry which serves the individual investor.

Second, certain outdated statutory requirements should be reformed. One example is Section 11(a) of the Securities Exchange Act of 1934, which requires that securities firms use unaffiliated floor brokers to execute orders for discretionary client accounts. This provision was intended to address Congressional concern in 1975 about the lack of institutional access to stock exchanges and the combination of money management and brokerage activities in single entities. However, the subsequent elimination of fixed commission rates and the opening of exchange membership to institutional investors has eliminated these concerns. Indeed, the only effect of this provision today is to create additional costs for the industry with no benefit to the investing public.

In conclusion, the industry is restructuring itself in response to cyclical forces and longstanding overcapacity, its financial health has probably ceased eroding, and the prospects for improved profitability appear reasonable. Thank you for giving me the opportunity to express my views.

6

U.S. Net Purchases Of Foreign Equities



Key Numbers

- With net purchases annually averaging under $4 million, U.S. interest in foreign equities was modest in the 1980-88 period.
- In 1989, U.S. net purchases of foreign equities reached a record, over $13 billion.
- U.S. interest in acquiring foreign equities has been sustained in the first half 1990, with net purchases totaling more than $6 billion.

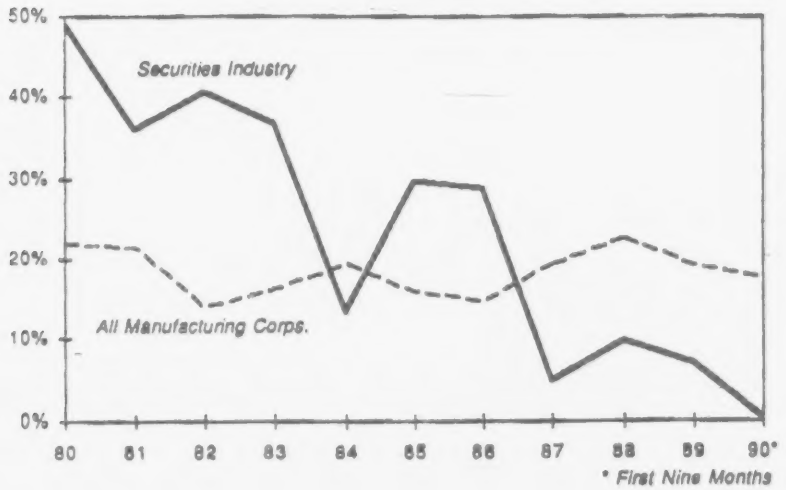
Insights

- U.S. investors influenced by Europe 1992, Germany, foreign M&A activity and new markets.

SECURITIES INDUSTRY

THIS SECTION INDICATES THE PERFORMANCE OF THE SECURITIES INDUSTRY IN TERMS OF ITS PROFITABILITY FOR THE DECADE OF THE 1980s. ALSO SHOWS DATA ON SECURITIES INDUSTRY EMPLOYMENT AND THE HOLDINGS OF U.S. EQUITIES.

PRE-TAX RETURN ON EQUITY
Securities Industry vs. All Manufacturing Corporations



Key Numbers

- Pre-tax return on equity (ROE – pre-tax profits divided by average equity) for the securities industry during the first nine months of 1990 fell to 0%.

- Since the 1987 stock market crash, securities industry ROE has been substantially below the ROE produced by the U.S. manufacturing sector, 17% in 1990.

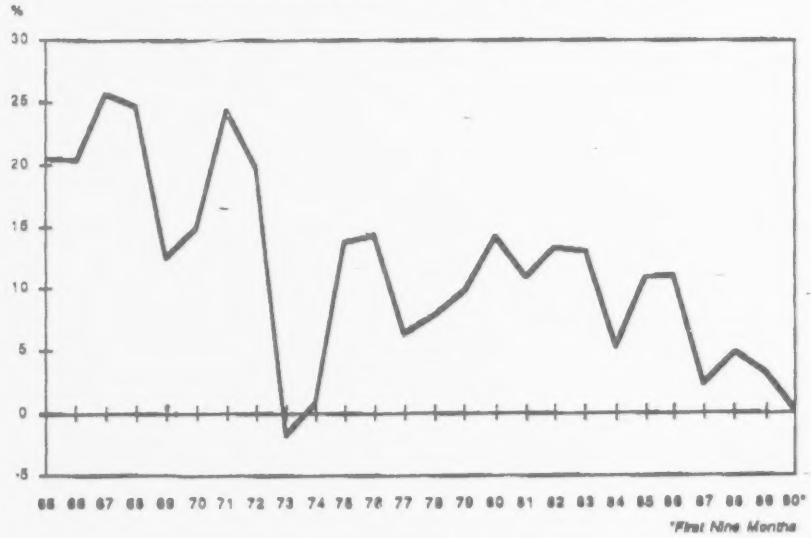
Insights

- The industry's 0% ROE through September, 1990, was the lowest return since the industry lost money for a full year back in 1973. The outlook for 1990's final quarter and 1991 is also bleak.

- Since the Crash, virtually all sectors of the industry have performed poorly and the industry is now in its fourth year of recession.

10

SECURITIES INDUSTRY PRE-TAX PROFIT MARGIN



Key Numbers

- Profit margins, profits divided by revenue,in the securities industry have trended downward for decades.

- In 1967, pre-tax margins were 25%, or in other words, firms kept 25¢ of every $1 of revenues generated before the payment of taxes In 1990 (through September), they kept 0¢.

Insights

- Although the securities industry grew rapidly in the 1980s and generated record revenue year after year, strong competition and the resultant narrowing of spreads earned in businesses led to declining margins. The crash exacerbated this trend.

11

SECURITIES INDUSTRY PRE-TAX ROE
BY TYPE OF FIRM

	1980-89	*1990**
Large Investment Banks	36%	11%
Discounters	34	19
Total Firms	26	0
Regionals	26	(1)
National Full Line	16	(8)

* Nine Months Annualized

Key Numbers

- During the 1980s, the securities industry averaged a 26% pre-tax ROE. Rates of return on equity were highest for the Large Investment Banks, at 36%, and lowest for National Full Line firms, at 16%.
- For the first nine months of 1990, Discounters fared the best with a 19% ROE, while National Full Line firms suffered a negative 8% return.
- Examples of different types of firms are:

  Large Investment Banks -- Goldman, Sachs; Morgan Stanley; Salomon

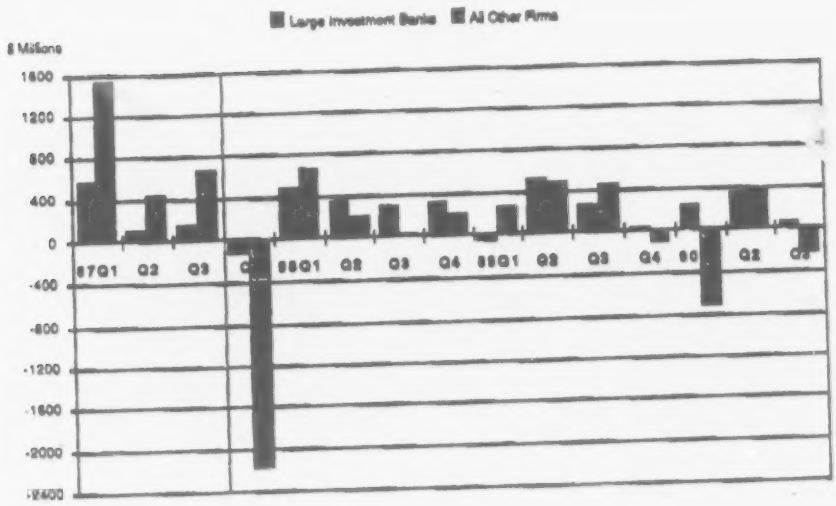
  National Full Line -- Dean Witter; Merrill Lynch; Shearson Lehman

  Discounters -- Fidelity; Quick & Reilly; Charles Schwab

  Regionals -- Alex. Brown; Legg Mason; Piper Jaffray

12

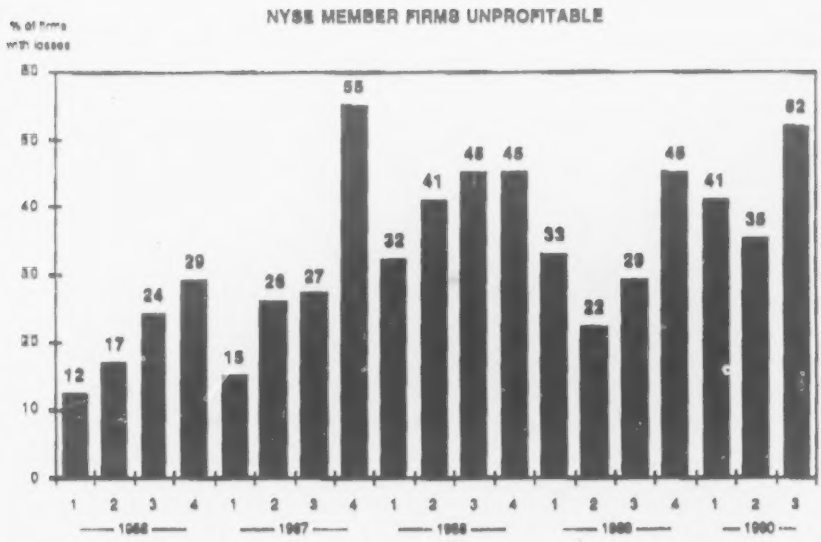
PROFITS: LARGE INVESTMENT BANKS vs ALL OTHER FIRMS



Insights

- Profits of LIBs have suffered the least since the Crash. LIBs' profits have equaled or surpassed the combined profits of all other firms quarterly since the Crash.
- Since the Crash, the only profitable segments of the industry have been investment banking areas, such as mergers and acquisitions, which are concentrated among the Large Investment Banks.

13



Key Numbers

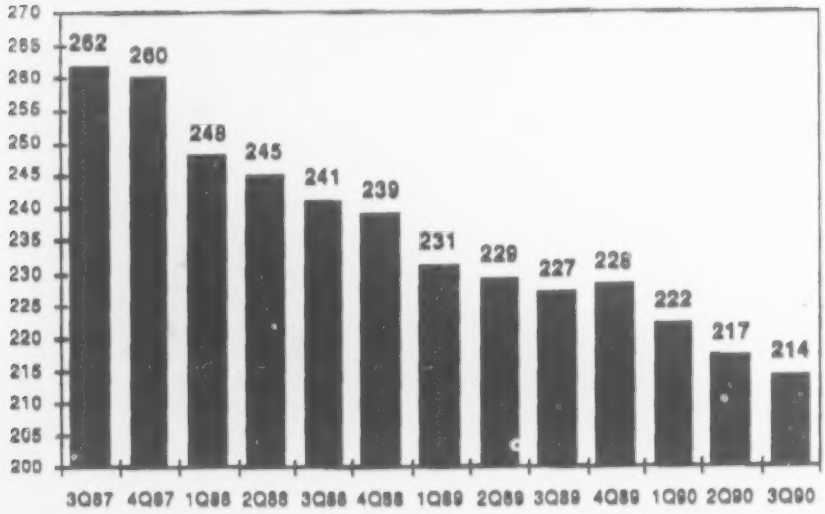
- Prior to the Crash, only about 15% to 25% of all New York Stock Exchange member firms showed quarterly losses. During the Crash-impacted 4Q87, over half of these firms lost money. Since then, roughly one-third to one-half of all firms showed quarterly losses.

Insights

- With one-third to one-half of the NYSE members showing quarterly losses for three years, many firms have closed or merged and most of the remaining firms have been forced to dramatically downsize in order to remain in business.

SHRINKING EMPLOYMENT SINCE THE CRASH

Securities Industry Employment in Thousands



Key Numbers

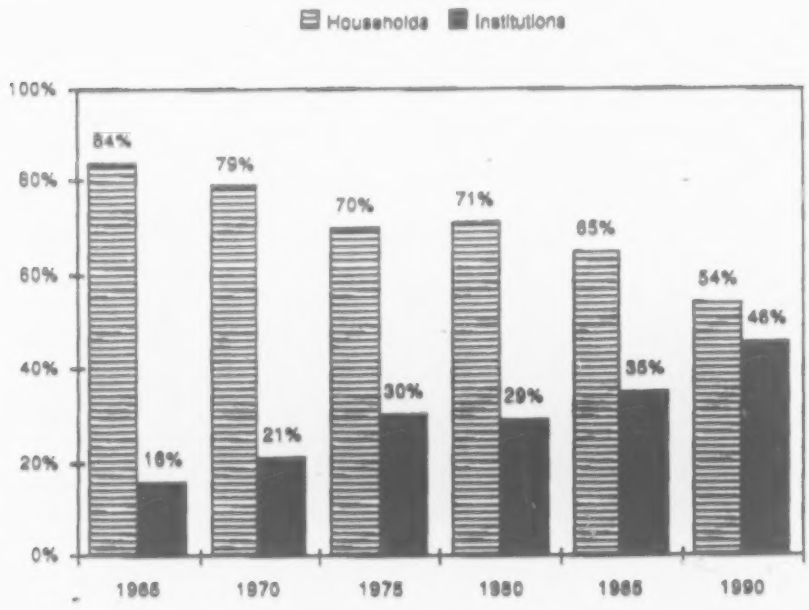
- Securities industry employment has fallen from its peak of 262,000 in 3Q87 (prior to the Crash) to 214,000 in 3Q90, a loss of 48,000 jobs or 18% of the workforce in three years..

Insights

- The downsizing on Wall Street has led to the closing or merging of many firms, including three major employers: E.F. Hutton, Thomson McKinnon and Drexel. The layoffs continue today and major firms such as Morgan Stanley, First Boston and Prudential-Bache, have announced plans to trim their workforce further.

15

HOLDINGS OF U.S. EQUITIES



Key Numbers

- In 1965, households held 84% of equities outstanding, and institutions 16%. By 1990, shareownership by individuals had dwindled to 54%.

Insights

- The "institutionalization" of the marketplace can be seen in the growing share of equities held by institutional investors, which has broad ramifications for market liquidity, volatility, etc.

16

SECURITIES INDUSTRY REVENUE GROWTH

	$ Billions		Multiple Increase
	1980	*1990**	*1980-90**
Mutual Fund Sales	0.1	1.7	17x
"Other Securities Related"	1.7	17.4	10x
Principal Transactions	3.7	13.1	4x
Total Revenues	**16.0**	**54.3**	**3x**
Underwriting Revenue	1.3	3.3	3x
Commissions	5.7	9.1	2x

*Nine Months Annualized

Key Numbers

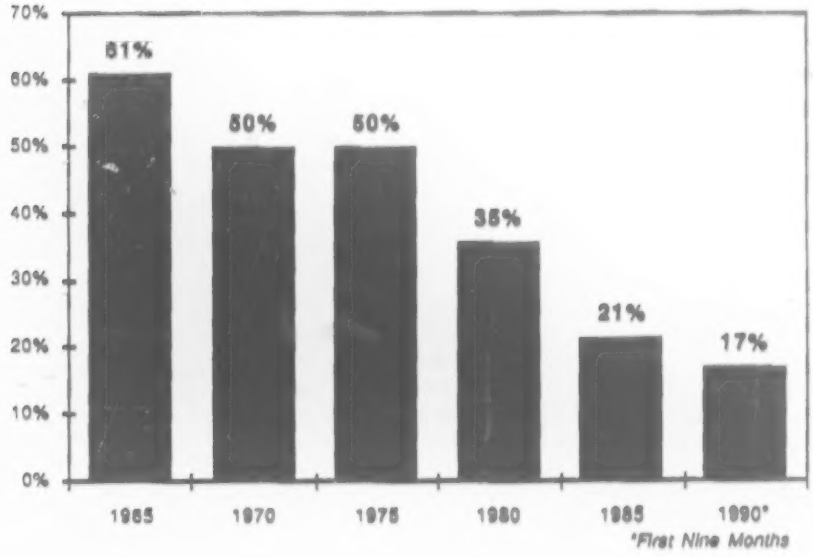
- Total revenues of the securities industry have increased from $16 billion in 1980 to to $60 billion in 1989, before falling back to an estimated $54 billion in 1990, based on nine month results, or an overall 3-fold growth.
- Reflecting the increased popularity of a new investment vehicle in the 1980s, mutual fund sales revenues were the fastest growing component, 17-fold growth.

Insights

- The diversification of the industry away from "bread & butter" business lines and into more risk-related activities is seen in the 10-fold growth of "other securities related" revenue that stems principally from mergers, private placements and interest income.
- Commission revenue failed to keep pace with overall revenue growth, increasing 2-fold in the 1980-90 period compared with average revenue growth of 3-fold.
- Another traditional source of industry revenue, underwriting, merely kept pace with the average during the period.

17

COMMISSIONS SHARE OF INDUSTRY REVENUES



Key Numbers

- The commission business has declined in importance to the securities industry. Over 60% of all revenues came from commissions in 1965. Today, commissions account for only 17% of total industry revenues.

Insights

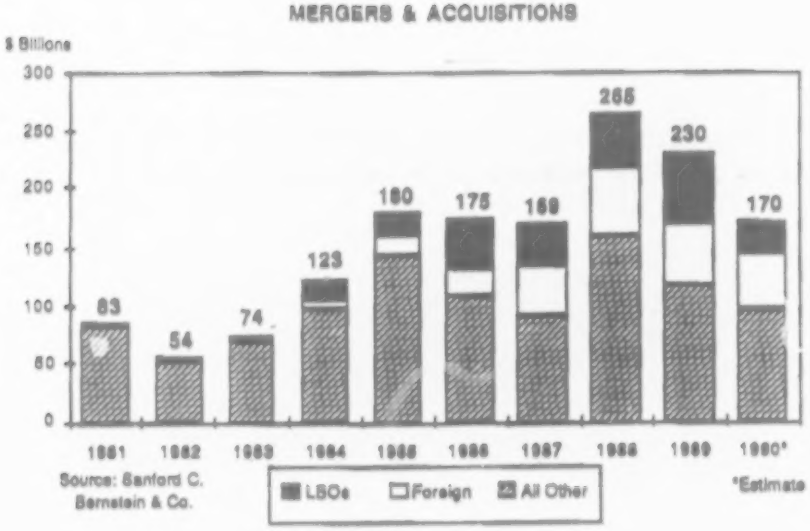
- The decline in the relative importance of the commission business, a safe agency line of business, has forced firms to seek profitability through more risky, principal lines of business such as trading, mergers & acquisitions, merchant banking, etc.

CAPITAL MARKETS

THIS SECTION INDICATES THE PERFORMANCE OF THE INDUSTRY IN UNDERWRITINGS AND OTHER FEE-BASED ACTIVITIES.

42-559 0 - 91 - 5

18



Key Numbers

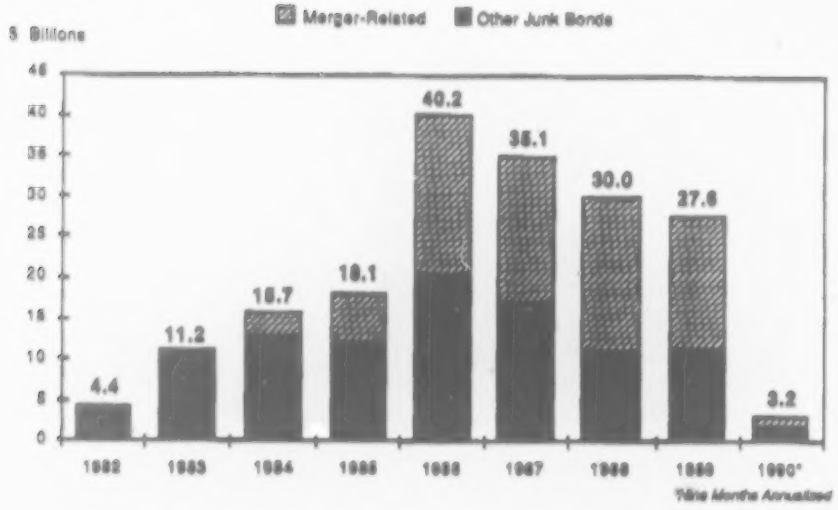
- Mergers and acquisitions (M&A) heated up in the 1980s, increasing from less than$100 billion annually in the early 1980s to a peak of $265 billion in 1988 before subsiding to probably $170 billion this year.

Insights

- M&A and ancillary businesses, such as junk bonds and bridge loans, were an important source of profits for the securities industry in the 1980s. With all of these products falling out of favor, the securities industry has few profitable business lines to turn to today.

19

JUNK BONDS UNDERWRITTEN



Key Numbers

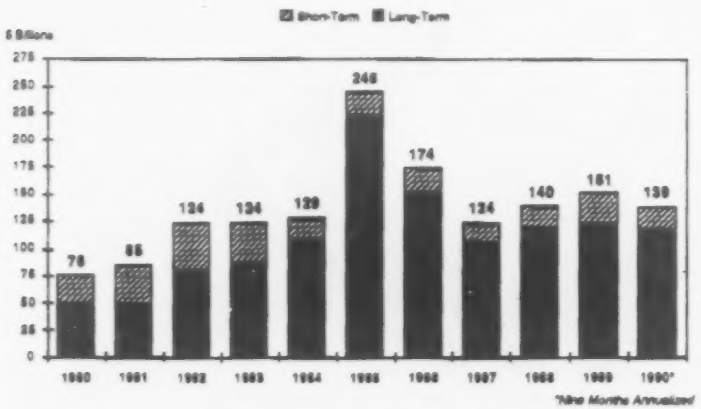
- The extent to which junk bonds have fallen "out of favor" is seen dramatically in the level of 1990 underwritings of these instruments -- only $3 billion (and possibly less) will be completed in 1990 compared with 1986's peak of $40 billion.

Insights

- The popularity and widespread use of junk bonds in the 1980s coupled with the trend of using tax preferred debt financing over doubly taxed equity, led to a high leveraging of corporate America. The 1990s began with problems from this high leveraging and the disappearance of this revenue source for the securities industry.

20

MUNICIPAL BOND UNDERWRITINGS



Key Numbers

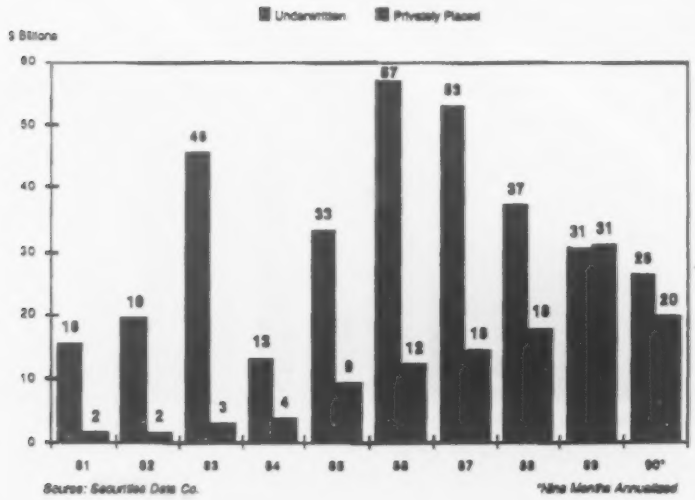
- Given tax code changes, municipal bond underwritings have remained stagnant after the early 1980s. After peaking in 1985 at $245 billion, due to a rush to beat out 1986's TEFRA, municipal bond underwriting has declined to about $139 billion in 1990.

Insights

- State and city infrastructure needs, and borrowing needs, have grown dramatically in the past decade. However, municipalities ability to borrow or finance these needs has remained at about the same level throughout the past decade.

21

NEW EQUITY ISSUANCE



Key Numbers

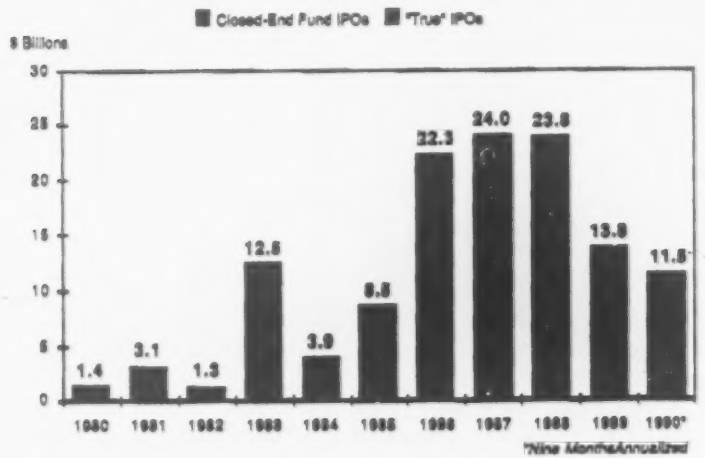
- This year's level of new publicly underwritten equity, $26 billion, is a far cry from the $53 to $57 billion underwritten in 1986 and 1987.
- Even privately placed equity (with large institutional buyers) is beginning to fall off.

Insights

- Investors' lack of confidence after the Crash has taken its toll on new public equity issuance. Individuals are shunning the direct investment in equities as institutions begin to dominate this market, putting pressure on liquidity and volatility.

22

"TRUE" IPOs HAVE CRASHED SINCE THE CRASH



Key Numbers

- Capital raised by new companies coming to market, initial public offerings (IPOs), has been a mere $6 billion per year for the past three years, reflecting adverse market conditions.

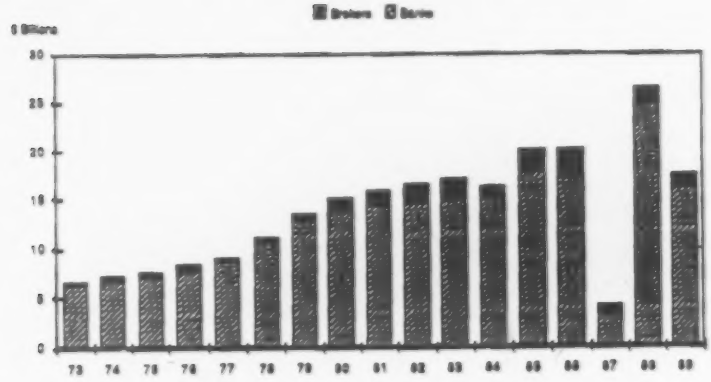
- Even closed-end funds, which fueled overall IPO issuance in 1987 and 1988, have fallen out of favor with investors.

Insights

- With the equity markets all but shut to new companies seeking financing, one of the few places new companies can turn to, America's small business community will find it difficult to grow.

23

BANKS vs BROKERS
After Tax Profits



Insights

- The profits of the banking industry have historically dwarfed that of the securities industry.
- Even if banks were allowed into every facet of the securities business, or even to absorb the entire securities industry, the profits from securities-related activities would do little for banks' bottom line.

Senator DODD. Thank you very much, Mr. Goldstein, for your testimony.

The questions I have will be for both of you. So you can respond in any order you feel appropriate.

Let me begin with both of you in the same place I did with Chairman Breeden, with the generic question.

You may recall I talked about what we witnessed up here over the last number of years with a variety of industry experts, regulators, all at various times telling us not to worry, things were fine, whether it was in junk bonds or thrifts or the FDIC and a variety of other things.

Only about $19 billion was raised in new public stock issues during 1990. That's down by 16 percent from what it was in 1989. And if you go back to 1986, around $60 billion was raised.

So, a substantial reduction in new issues.

Obviously, the questions that are raised are what you were addressing in a sense, Dale, in your opening remarks. And that is:

Given the historic ability of the securities industry, the role that it has played in raising funds from the Nation's investors, and channeling those funds to businesses and to governments, local governments, where needed, it really has been the engine of capitalism.

And we're watching what we hope is only a cyclical change but, frankly, you point out what's happening in Europe and elsewhere. For many years, America was the place to invest. There was no other place really. Now, we're in a highly competitive global market in terms of where is an attractive place to place your capital.

So the attractiveness of our markets is going to be a major, major question. And if banks are under pressure, as we know, and the insurance industry also is in weak condition as we know it is, what prospects do you hold out for the securities industry for saving that historic capital raising role that it has in the past? And what needs to be done?

Both from an industry perspective and any recommendations you have for us. I mean, that's important as well.

And, Dale, I'll begin with you.

Mr. HOROWITZ. Let me say from an industry perspective as opposed to what needs to be done.

I don't have a great concern that the securities industry can fulfill its role as a financial intermediary. I think Chairman Breeden mentioned the amount of capital in our industry. I think the capital remains.

There is a certain amount of history which is applicable here. We have been through a number of cycles like this—not with all the same outside conditions. I mean, I remember 1970 very well, having been a long time, and we had a good number of firms, even before SIPIC, go out of business. Firms like Good Buddy, Shearson, which came back in another life; Haydenstone, McDonald and Company, all these firms disappeared.

And some of the same concerns existed then as exist today. The industry I think can fulfill its role. We're in a recession. I think that has a major effect.

I would point to you to a couple of positives.

One, I have got a number here which is almost make-believe, but I'll read it to you because I think it has some meaning.

With rollovers, with new funds raised and with Treasury bills sales every week and 3 months bills maturing every 90 days, and the like, the volume of Treasury securities sold at auction in 1990 was $1.564 trillion.

Senator DODD. Read that to me again?

Mr. HOROWITZ. Yes. It's $1.564 trillion. That comes from our research department. I assume it's correct. Which means that's a lot of rollovers. You sell 90-day Treasury bills four times a year. You sell 6-month Treasury bills twice a year. You roll over 2-year bonds as they mature.

You roll over 4-year bonds.

But, all those securities were underwritten by the securities industry, to some extent with participation by commercial banks. But, the industry I think fulfilled its function there.

I mean, you read in the paper the way I would read:

Oh, the Japanese aren't buying this year. This time, the Europeans aren't buying. The dollar is up. The dollar is down.

All through that, the industry performed its function and underwrote these securities.

Now, as to the volume of that goodie, part of the figure from 1986 to 1990 is I think significant because 1987 came between 1986 and 1990. And equities get sold when companies think they can get the maximum price for their equity, not the minimum price. I mean, we've had a tremendous drop-off in IPO's, you know, initial public offerings. We'll be glad to bring them to the market if people want to sell them, it's that people who own these companies think they're worth more under the current system with the stock market in the condition that it is.

Senator DODD. Or at some point they'll be worth more. They may not be worth more that day.

Mr. HOROWITZ. Well, but they even think they're worth more today, believe it or not. So—you have to own privately and have an interest in it. IPO's is a very interesting business by itself.

But, on the other side, if we increase our saving rate, if there's a bigger pool, if we do something about retirement systems—somebody retires. You know, people move from job to job these days. It isn't like when they worked—people aren't like me. They haven't worked 35 years for the same firm. They go from firm to firm. Their pension benefits change.

I think there has to be a look at that.

Senator DODD. By the way, Mrs. Dole was very interested in working on legislation in that regard. I don't know where Lynne Martin comes out on that question, but there seems to be a stronger interest in the administration regarding the portability in those questions, which is going to be very helpful.

I didn't mean to interrupt you.

Mr. HOROWITZ. The IRA's are simple things. I mean, small savers for their own retirement, limited. Real pools of funds.

Senator DODD. Do you agree with the conclusion by Shearson, who did the study, that, in fact, it generated new savings and not just shifted savings around?

FINANCIAL RESTRUCTURING

Mr. HOROWITZ. Yes, yes, we do.

And, of course, I think the other thing is financial restructuring. We have to do something about the viability of our banking industry. And I think that's an issue, which, as I said in my remarks, I think that it's got to be addressed.

Senator DODD. Mr. Goldstein.

Mr. GOLDSTEIN. I'd like to make one point on equity capital raising. The arguments I've heard today I find to be rather persuasive toward a future boom in equity underwriting. I think the outgrowth of the levering cycle that took place from, roughly, 1982 to 1989 was an unprecedented rise in debt to equity ratios. And we have seen the financial stress that that's created this year. And now again we'll probably see it in 1991.

I think that's a powerful argument that, in the next upturn in the equity markets, we'll probably see a historic boom in equity underwriting.

So I don't have a particular concern there. I expect that to be, in fact, a major component in the future profitability of the industry.

One other point I'd like to make that was mentioned earlier. There's concern about investor sentiment toward money market funds.

Senator DODD. Yes.

MONEY MARKET FUNDS

Mr. GOLDSTEIN. That money market funds own about a third of all commercial paper in the United States and they've grown rapidly at the expense of banks and thrifts.

What happens is banks and thrifts pay deposit premiums; money market funds don't. And if you examine the difference in cost structures and yields, that's the difference between the two types of investments.

I think the need to further regulate commercial paper holdings by money market funds is real and the prospect of a money market fund being unable to refund commercial paper default is the biggest single threat to both the money management industry and the securities industry because money market funds have become the foundation of the money management business, which provides a massive cross-subsidy to the transaction-oriented activities of the securities industry.

Senator DODD. How big a risk is that, in your view?

Mr. GOLDSTEIN. That's highly debatable.

Senator DODD. Oh?

Mr. GOLDSTEIN. There's two schools of thought. One is that the market is efficient and self-correcting and that money market funds tend to buy the safest paper. That it would fund, for example, automotive receivables issued by General Motors.

On the other hand, you might argue they own a third of all the paper, so the odds are stacked against them.

Given the fact that investors expect no losses and, indeed, enjoyed a dollar net asset value for more than a decade now, I, myself, tend to lean to the latter camp, that the odds are stacked

against them, because they own such a large portion of all the paper.

And there are no reserves.

To date, losses that have been taken have been able to be funded by the management companies that offer the funds.

The ability of the industry to do that on any large scale is extremely limited and, in fact, they couldn't do it.

Senator DODD. Yes. Does the fact that—I'm sensing here that we're not at the bottom of this recession, by any means—does that contribute to the conclusion that you're reaching?

Mr. GOLDSTEIN. Yes, and you could see it in the valuation of the companies that offer money market funds. The market believes that as well.

Senator DODD. That's interesting.

Do you have any recommendations on that front?

Mr. GOLDSTEIN. Oh, I think the basic direction that's been taken is to limit the holdings of lower grade commercial paper. I guess that's the best recommendation.

Senator DODD. The point was raised with——

Mr. GOLDSTEIN. That's right.

Senator DODD. And you agree with the direction he's going?

Mr. GOLDSTEIN. Yes, I do, in principle. The risk to that is that presumes that the rating agencies that set the ratings are, in fact, always correct. The extent they fail, that direction will also fail. But, I think that's inevitable.

Senator DODD. OK. Let me stick with you here for a second, Mr. Goldstein, and let me ask you:

What do you think the long-term prospects of the industry are?

LONG-TERM PROSPECTS OF THE INDUSTRY

Mr. GOLDSTEIN. I think they're good. It's always been a highly cyclical industry. I think, on the retail side of the business, where most of the firms are engaged, we're going to see massive consolidation. The reason is there's been a long-term trend toward lower holding of equities by individuals and that's what those firms do. They facilitate the turnover of those equities.

I expect what we'll see is many fewer firms in a closer integration between money management and the distribution process. But, basically, I think the industry is in fairly good condition.

Senator DODD. Let me go to the individual investor question you addressed, Dale, a bit in your comments. We talked about it with Chairman Breeden a bit.

I find myself going back and forth on this question. And I'm not an expert here at all. But, there's a part of me which may be a bit of nostalgia when we talk about the individual investor. But I also hear enough people whose judgment and expertise in this particular field I trust who say,

No, this is not just nostalgia, Senator. We're talking about stability and liquidity in the market. And if you lose the individual investor you're really jeopardizing that. This isn't just the nice idea of having 50–60 million people out there investing and putting their hard-earned money up to capitalize the needs of this Nation.

And, yet, You all know the numbers. You don't need to hear them from me. The institutional investor's percentage of the

market is growing, the anticipation is that it's going to hover around 70 percent, I think, by the end of this decade, if it isn't almost there already.

If, in fact, it's important beyond just the retail outlets and the business that generates to have that individual investor here for purposes of stability and liquidity, what has to be done? And, second, how does institutional dominance impact on the individual investor?

INDIVIDUAL INVESTORS

Mr. HOROWITZ. I was going to say how much time have we got? That's an omnibus question. I'll give you, hopefully, a reasonably short answer.

One, I don't think nostalgia is the only thing. I think we need the individual investor. I will say that the SIA tries pretty hard through its own education—we have a separate education foundation which in I think 48 out of the 50 States now runs something called the stock market game, which is done in schools. It seems not only to teach people about the stock markets, it also teaches them to read and use numbers and the like.

We do run seminars for registered representatives all over the country. We're very, very supportive in the way we can get to the individual. You know, there are over 600 members of the SIA—not all of them at Solomon Bros. A lot of them—most of them—are just the opposite. They're very small firms. And we do everything we can to assist them to educate the individual investor.

There is no question that, as an individual investor approaching a monster market, you have to be scared.

And I think, to some extent, that's led to the institutionalization of the individual investor's funds. And we have mutual funds. The pension fund is nothing more than an institution that holds individuals' funds.

Senator DODD. Yes.

Mr. HOROWITZ. And so the individual is in the market very, very big. But, the individual is in the market through a single investor.

Of course, this has created problems and we've done one of the things which scares individuals away It's put a premium on performance. I mean, Michael sits here and he rates the—I don't know if that's the right word, but he judges the securities firms in the industry. He judges our performance, everybody else's performance. And these performances are not judged over a year or 2-year period. They judge it best over a quarter. Sometimes, they're judged over a week or 2 weeks.

Senator DODD. Yes.

Mr. HOROWITZ. So that—and this puts the pressure on the fund that holds the securities, that holds the stocks to perform also. So it creates more volatility. They sell. They buy.

On top of which, without the individual investor, and let me tell you why we truly need them, the commission income of this industry has declined to the point where it has affected I believe liquidity on the stock exchange.

Years ago, if somebody came in with a block of 500,000 shares, we would give them a bid on 500,000 shares. Now we'll give them a

bid on 100,000 shares and take an order on the other 400,000. In the old days, we would give them a bid on 500,000 because we would be paid a commission which would make it worth our while to take the risk.

Now, when you talk about 2 or 3 cents a share, I mean, there just is no reason for us to take the risk.

So, now those 400,000 shares sit out there and they create a downward pressure on the market, creating greater volatility.

So, we'd love to see the individual return in——

Senator DODD. Well, what do we do about it?

I totally agree with you. I think it's desperately important. But, the trend lines indicate absolutely the opposite is happening. Bill Donaldson pretty much paraphrased what you just said about the volatility of the market, the depth of the market. And I saw a week or so ago a similar report in one of the newspapers.

I don't think I ever had anybody before this committee stand up and say, "the hell with the individual investor. Wake up, guys, this is about the end of the 21st century and the idea that you're going to have a retail market out there of any significance in the future is a joke."

Now, no one says that. And so I accept when I hear industry experts and knowledgeable people like yourselves talk about the importance of individuals important.

And, yet, I've never had anybody really say to me: "Senator, let me tell you what you've got to do. Here are the three or four or five things that must be done if we're going to reverse that trend and bring that individual investor back to the market."

Mr. HOROWITZ. Do you have a response? [Laughter.]

Mr. GOLDSTEIN. No, I don't. That's an excellent point.

Senator DODD. Do you believe it? Do you think it's important?

Mr. GOLDSTEIN. Do I think it's important? I think, in particular, for small capitalization stocks and support because there's a large individual constituency and there's a body of empirical evidence that shows the liquidity of those stocks has declined over many years. So I believe it's important.

Now, on the other hand, it's hard to prescribe what to do. The one thought that comes into my mind is there's a lot of talk about Glass-Steagall reform and giving more securities powers to banks. So, when you look at the sheer size and distribution capability of the banking system vis-a-vis the securities industry, it's much larger and, in particular, there's a clientele effect.

There are certain people that like to deal with their banks. To the extent banks become an arm to distribute information about securities, I think that adds legitimacy of it. You're radically broadening the distribution. And that may help.

On the other hand, the secular trend is among the most powerful I've seen in financial services and I think it's also in part due to the fact that you've created the mutual fund industry that markets its products very effectively and in a very sophisticated manner.

You don't see that same kind of marketing for the concept of buying individual stock. And I think that has furthered what was already a powerful secular trend.

Senator DODD. That's a good point on the Glass-Steagall issue. We made the case that families today, whether it's a single parent

running a household or two income earners, one stop shopping is a very attractive notion and idea.

Mr. GOLDSTEIN. Also, if you look at the fundamental economics of the retail business, for a retail broker to take his time with someone, they have to have substantial worth because he invests a lot of time and there's a given turnover rate.

And to the extent you diversify distribution of the product, you lower the minimum requirement for attention and you probably broaden involvement.

Mr. HOROWITZ. Can I just add one thing? Let me just say one thing. I guess, in response to Michael about our own industry, we have firms—I can name them, like Edward B. Jones, like Raymond James—which are all over the country doing this. And I would not want to denigrate their records at all by saying, you know, that banks can do a better job. I think they can do a helpful job. We have said pretty clearly we have no objection to the banks being in the business under the right circumstances.

But I think the industry in that sense does a good job.

There are two elements, one which is almost a given, which is confidence. And I don't know what that confidence means, whether you're talking about program trading, economy, whatever it is. That's a nice generalization, but it's a fact.

The other is tax policy. Somebody could use his IRA to buy stocks, you know, and they're not worried about the tax consequences, they might buy stocks from the IRA—if the corporation paid the tax on the dividend only once and maybe the investor didn't have to pay the tax on the dividend. Or the other way around. If there was something done on double taxation of dividends and there was a tax reason for investors to come back, individual investors, come back to the market, that might work, too.

But, just some suggestions. It is not a quickly soluble problem. I agree with you.

Senator DODD. You made a couple of suggestions here. I'm hesitant about speaking for my colleagues, but I think, generally, there's a strong desire on the part of the committee to do what we can to bring the individual investor back. Clearly, the program-trading elements of the market reform legislation were reflective of the fact that people wanted to do something about that, not just in responses to the notion that it contributed to the market breaks in 1987 or 1989, but rather the sense that it was scaring off the individual investor.

I think that was a lot of the motivation.

So I would appreciate maybe taking a look at that question. You made a couple of suggestions here already. Some of them are going to be politically just unacceptable, I would suggest, and I don't mean just to this particular committee or to the Congress, but probably to the White House as well.

And I would be most appreciative to have a short paper from the SIA. And, Michael, I would appreciate some of your suggestions as well.

Let me ask you, Dale, if I can about the one point you raised. I would be derelict in my responsibilities here if I didn't ask you to comment on the overall question of financial services reform. I wonder if you might take just a couple of minutes and give us a

sense of where the SIA is today. None of us have seen the administration's proposal and yet we're getting a pretty good idea from various news stories as to where they're going to come out on all of this.

Where is the SIA in this debate?

FINANCIAL SERVICES REFORM

Mr. HOROWITZ. Let me make a partisan statement first. I'll say the SIA is ahead of everybody else. And that's the end of the partisan statement, but I guess it's a little frustrating to me.

We, for years, stood on the battlement of Glass-Steagall and said no, no, no, no, no. And we have now said:

Look, there's a bigger interest out there. Let's get it down and let's get everything worked out.

Nobody else has been forthcoming. The only ones working on anything as far as I know is the administration. None of the other trade groups or anything else has done anything.

And I have to say—I said in my talk, I talked about a summit. I'm concerned that the administration will come out with a bill and there'll be this bill and that bill and then we'll go through what we've gone through every time these things have come up. These special interest groups will come around—we're a special interest group. We'll come around and start picking at it.

If something could be done. If Congress writes the laws, if something could be done where a group bill was drafted, get the people before they start nit-picking. Tell us what your problems are before we bring the bill to the floor, or to committee. Then maybe something could get done.

But, we clearly feel that there are two elements. One is taxpayer protection, which—and I'll get off the partisan statement. It's taxpayer protection, which is separation of deposit-taking, insured deposit taking from any securities activities. Other activities are not our purview, but securities activities.

The other issue for us is equal competition. As long as the playing field is level, we are fully prepared to compete with anybody. We don't believe that anybody should be kept out of this business. People can come in this business.

We do agree that it's essential for, although not the main part of international competitiveness, but it is essential for international competitiveness for the banks to be in the securities business. And we think that we should go forward and get it done.

We believe very strongly in very high and very tight firewalls around the insured institution so that the taxpayer doesn't end up paying for risks again.

We don't know how to handle the question of safety net.

Even if we have an uninsured institution there's going to be a safety net. And there is no safety net around the securities firm that decides not to become a bank.

One of the ways, I think, and the chairman alluded to it when the question of regulation was asked, was if we have this uninsured fund-raiser bank that owns a securities company is by capital, very strict capital. And the same kind of functional regulation that we

get where the SEC watches every day, and we mark the market. And they know where we stand.

But, if we can overcome the safety net issue—I mean, there are other issues. Where should foreign exchange be traded? Foreign exchange is a trading operation. It started out as basically a clearing operation, but now it's become a major trading operation. Right now, it's traded in the insured part of the bank.

Should it be moved to the uninsured part?

These are some of the issues.

Senator DODD. Yes.

Mr. HOROWITZ. But, on a broad-based scale, if the depository institution—the insured depository institution is removed from risk in the securities business, then we say everybody should be in——

Senator DODD. Well, I, of course, as you know, endorsed your notion about trying to get people together before we come out with six different bills kicking around here. And I think that makes some sense.

Whether or not we're going to be able to do it that way is another matter. But I think it's a very sound suggestion.

And in the brief conversations I've had with some people at Treasury—I addressed that point. I spoke of it more in the context of the committee and the institution here but, obviously, the interested parties outside, the people that are going to be directly affected by what we do, should be involved.

As you know, in the past, Senator Garn tried that approach about 10 years ago. Less than 10 years ago. What I call the Cats in the Box Theory. And the box got destroyed. [Laughter.]

The cats are still around, but maybe we're seeing a better box, I guess, or something——

Mr. HOROWITZ. Well, but there is a difference.

Senator DODD. There is a difference today. There clearly is a difference, a major difference in terms of——

Mr. HOROWITZ. We believe as strongly as the banks that we have to have a strong banking system.

Senator DODD. Yes.

Mr. HOROWITZ. We probably would have fought them 10 years ago.

Senator DODD. No, 10 years ago.

Mr. HOROWITZ. 15 years ago.

Senator DODD. 5 years, 3 years, 2 years. [Laughter.]

Mr. HOROWITZ. Thank you.

Senator DODD. Anyway, do you want to comment on that at all, Michael? I don't know if you have any thoughts you want to share.

Mr. GOLDSTEIN. I basically agree with what Dale was saying. I think functional regulation is appropriate, but I do think you need some oversight of the holding company. My experience with securities firms has been the absence of disclosure of holding company activities can produce some surprises for everyone involved.

Senator DODD. Yes [laughing].

You're the master of the understatement, Michael.

Mr. GOLDSTEIN. So I suspect you need at least disclosure and a minimum of what's happening at that level.

Senator DODD. Yes. OK.

Let me, Dale, turn to you for one last set of questions.

You are currently serving as Director of the Municipal Assistance Corporation in the city of New York. God bless you. [Laughter.]

I don't know how you've managed to do all of the things that you're doing, because that in itself would be a fulltime occupation.

Mr. HOROWITZ. I work for a very good firm in spite of what you read in the newspapers, very, very proactive and pro-concern firm.

Senator DODD. Yes, they are. And you have been.

And I, frankly, was delighted to hear you talk about education and health care and the condition of infrastructure. New York is the most visible example of what's occurring, but you can go anywhere you want in this country and find it to one degree or another. I spoke yesterday at New Briton High School in Connecticut, to the Government class that I do once a week to a public high school in the State some place, and talked with the principal there.

He's telling me that every year that he's been there, they've had a reduction in operating costs around 8 percent, or something like that. They try and deal with teaching these kids in a population that is 50 percent minority in that high school. They've got expanding classroom sizes but reduced personnel. There are obvious questions of competitiveness and job training and dropout rates and all the other problems going on.

New Briton is not a small town. It's a city, a small city. It's not a major urban area. It's on the fringe of Hartford.

We're watching tremendous pressure on local governments and the ones we read about in New York and Washington, and so forth. But, you can go anywhere you want in this country and pretty much find those kinds of pressures. And, obviously, the debate and wrestling with whether you raise taxes or cut expenditures and normally towns cut rather than raise taxes for obvious reasons.

And then you look at what's happening at the municipal bond market—one of the major funding sources for local governments to meet these needs.

Again, I come back: How do you view the overall safety of the municipal securities market? And what should we be doing about it?

MUNICIPAL SECURITIES MARKET

Mr. HOROWITZ. Two separate questions. I think, for the most part on the safety, historically, this has been probably I guess the safest market. I think it will continue to be. Municipalities have a way of paying their direct obligations. We've had some problems on hospital bonds and things like that. But, for the most part, I think on the tax bonds and the direct revenue supported facilities, the municipalities have a very, very good record.

They do have a certain amount of taxing power. They do have a certain amount of resources.

On the other side, on the municipal bond market, I think that the watershed for that was the tax act of 1986. I think that what happened there is that the pendulum swung too far. Tax exemption has always been a dirty word in Washington. The Treasury has never liked it.

Senator DODD. I don't think it's always been a dirty word. It got to be so recently.

Mr. HOROWITZ. No, it goes back to Stanley Surrey in the early 1970's in the Treasury. I spent most of my career in this business and I know a great deal about it.

Senator DODD. You're expressing your personal view, but——

Mr. HOROWITZ. I know, but it——

Senator DODD. I voted against the 1986 bill.

Mr. HOROWITZ. Yes, there were clearly abuses. Tax exemption was used for things it shouldn't have been used. Arbitrage abuses, the advanced refunding abuses.

But, what happens in a case like that? The pendulum which had swung over here swung too far this way.

It's not even so much that you limited the purpose. And I don't say you, I mean the Congress.

Senator DODD. I understand.

Mr. HOROWITZ. You took most of the buyers out of the market. It was a very small market as it was. And you said that commercial banks can't use a deposit against tax exemption and you made the tax treatment of casualty companies and you reduced it to simply an individual market.

And the individual who had been the traditional residual buyer of municipals now became the prime buyer. And the market was too small for the volume required, so we had a drop-off from over $200 billion. Let's assume that $20 billion of those were for stadiums or stuff that shouldn't have been done, or even $50 billion.

So we went from $170 billion to $100 billion. And cities can't finance properly. And they cannot bring themselves to use the tax in the market, the spread would be just immense.

You've taken away what I believe was an honorable subsidy. It was a subsidy.

Senator DODD. Absolutely.

Mr. HOROWITZ. It was the best subsidy. It came with no strings. You didn't have to apply for it or anything else like that. Absolutely no strings. It was the perfect subsidy—and you took it away. Or, you reduced it considerably.

And now cities and States are suffering because of it.

Senator DODD. Yes.

Mr. HOROWITZ. I mean, I can't tell you how perfect the subsidy was. Nobody had to file a paper. There was no cost. There was no organization here. We had to go to get new subsidy. It existed.

Senator DODD. Yes.

Mr. HOROWITZ. And to a large extent, it's gone. And it's hindered our cities.

Now, I also think there are a lot of other considerations. Why school districts that don't need the money in States get money has a lot to do with political concerns, not other concerns. There are plenty of wealthy school districts that should be willing to help for the overall good of the State. It doesn't happen. That's a whole——

Senator DODD. That's another political question.

Mr. HOROWITZ. But it's a serious thing.

Senator DODD. Well, let me tell you what's going to happen. I'll make a prediction for you. Not only are you going to have that situation, which is deteriorating—and I couldn't agree with you more

about it. You know, looking around over the last 25 or 30 years, I'll state a percentage, and I may be off on this.

I would guess that 70–80 percent of all of the infrastructure which occurred in this country at the local level occurred under that particular program. It did not occur with appropriations out of Congress.

And the idea that somehow we were going to make up that gap through public works funding was about as naive a thought as I've ever heard.

But, let me tell you what's going to happen now. In Connecticut, we're faced with a huge deficit. A number of States are. New York is, certainly. California is. Connecticut may be the worst in the country.

Taxes are a tough question. Seventy percent of the people in Connecticut don't want a State income tax. Now, that's where it is today. Whether you think it's right or not, the realities are, politically, you're probably not going to get it.

So, instead of raising taxes, do you know what we're going to do to pay for this thing? We're going to bond it. And instead of building infrastructure and schools and health care facilities, we're now going to bond our deficit because that's an easier way to go.

Mr. HOROWITZ. But, let me just say one thing.

Washington can't escape another part of the blame. You've cut revenue-sharing. You've cut—in the 1980's, you look where the revenues of the cities came from in the 1980's. There are some figures which I don't have. The ABPSA can give them to you.

The percentage of revenues of cities from the Federal Government has declined substantially.

Senator DODD. Sure. Housing, transportation——

Mr. HOROWITZ. And they're good programs.

Senator DODD. Yes, down the line.

In fact, we're going to do some hearings. I know the chairman is interested in this subject as well. Detroit is facing some serious problems. But we want to do some broad-based hearings on this question itself, how we deal with it. And you've made some suggestions already in terms of tax policy, which I agree with you on.

Let me leave the record open for any additional questions that the committee may have for both of you. And thank you for being here this morning.

We haven't exhausted the subject matter. But, this is an active subcommittee and part of holding the hearing today was to evidence that.

And we intend to remain active and will be holding a series of hearings on various aspects of the securities industry.

We've got some "must" things we have got to do this year, because reauthorizations are up.

We appreciate particularly the industry's support on the SEC issue.

From the SIA, that's a very appreciated position, and we really need your help. When you're talking to Members of Congress about specific agenda items, we would truly appreciate it if you would put the SEC pay issue high on the list, because without your support, we're not going to be successful in dealing with it. I don't

need to tell you what will happen in terms of the quality of personnel that will be needed.

So, again, I thank both of you as well as Chairman Breeden for participating today. It was a long hearing—a little over 3 hours. I apologize to you.

But, as I say, we haven't exhausted the subject matter.

Thank you very much for your attendance.

Mr. HOROWITZ. Thank you.

Mr. GOLDSTEIN. Thank you.

Senator DODD. The committee will stand adjourned until further call of the chair.

[Whereupon, at 1:07 p.m., the Committee adjourned, to reconvene at the further call of the chair.]

[Response to written questions and additional material for the record follows:]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

February 26, 1991

The Honorable Donald W. Riegle, Jr., Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Riegle:

In response to your letters of January 10 and 14, 1991, please find enclosed my responses to questions posed by you and Senator Sanford in connection with my testimony before the Securities Subcommittee on January 8, 1991. Please do not hesitate to let me know if I can be of any further assistance.

Sincerely,

Richard C. Breeden
Chairman

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

RICHARD BREEDEN

Questions of Chairman Donald W. Riegle, Jr. -- Letter of January 10, 1991

Q.1. Deposit Insurance Reform

In September 1990, I introduced the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act" containing my proposal for reforming the Federal deposit insurance system. I understand that you have had an opportunity to review this proposal. Do you have any comments that you would like to offer?

A.1. In general, the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act," which you introduced last fall, contains a number of very useful suggestions for reforming federal deposit insurance and for strengthening supervision. Indeed, introduction of this legislation last year undoubtedly helped in the formulation of other reform proposals.

There are a number of particular provisions of your bill that would represent very significant improvements to the current system. For example, one of the key principles of your proposal is reinforcing the role of capital in enhancing the solvency of our banking system. Some form of prompt corrective action is necessary to avoid repeated significant losses to the deposit insurer. This type of early intervention has been effectively used by the SEC to ensure that firms which reach a critically low level of capital are closed or recapitalized before capital is exhausted, so as to prevent losses to customers or the Securities Investor Protection Corporation ("SIPC"). Your proposed capital-based assessment system underscores the importance of capital for insured institutions.

I strongly agree with the stated objective in your bill that accounting principles applicable to insured institutions accurately reflect the financial condition of those institutions. Capital is only effective in reducing risk and providing a cushion before taxpayer exposure if it is accurately and realistically measured. Items such as good will or unrealized losses on securities do not provide any buffer for absorbing losses, and hence should not be included in the computation of required minimum capital levels. Your provision requiring the SEC to facilitate the development of market value accounting principles would help to ensure uniformity and reliability that would benefit investors and facilitate effective supervision. In addition, your proposals requiring annual examination of banks and thrifts, market value estimates in reports, and conformance with GAAP would also improve the accurate measurement (and consequently the real value) of capital.

Another major problem addressed by your bill is the significant overcapacity plaguing the banking system. This situation has been exacerbated by the spiraling increase in the

federal safety net in recent years. Several provisions of your bill would serve to limit the scope of deposit insurance, which is a step in controlling unnecessary exposure for the taxpayers.

Another very useful step proposed in this legislation is the limitation on the FDIC's ability to pay uninsured claimants. In my personal view, payments to uninsured persons or entities should be capped at some appropriate fraction of the amount deposited, as originally recommended by the Task Group on Regulation of Financial Services in 1984. In the intervening time the so-called "too big to fail" doctrine has protected uninsured depositors and creditors, leading to an extension of the federal safety net and eroding marketplace discipline.

On the whole, the numerous specific proposals in this legislation, coupled with the forthcoming legislative proposals of the Treasury Department, provide a very serious and useful starting point in developing comprehensive legislation.

Q.2. While we are reviewing the health and stability of the Federal deposit insurance funds, we should be careful to review the stability of the SIPC, which protects securities and cash held by broker-dealers on behalf of customers. I wrote a letter, dated March 19, 1990 to the GAO requesting that they review the adequacy of the SIPC fund. The response, prepared by SIPC, indicated that it is not possible to calculate the dollar amount of SIPC's exposure to loss since the amount changes on a moment to moment basis.

Q.2.a. In light of the difficulties of calculating SIPC's exposure, how can SIPC, or the SEC which has oversight responsibilities for SIPC, determine whether the SIPC fund is sufficient?

A.2.a. Based on our latest information, the SIPC fund appears to be well-capitalized in comparison with any reasonably foreseeable broker-dealer failures. As of December 31, 1990, the SIPC fund totalled $568.6 million. This was its highest level since SIPC's inception in 1970. In addition, SIPC has access to a $500 million line of credit established by SIPC with a consortium of banks. SIPC also has the statutory authority to borrow up to $1 billion from the United States Treasury Department through the Commission. As a result, a recent study 1/ concludes that SIPC has sufficient resources and liquidity to

---

1/ Deloitte & Touche, Special Study of the SIPC Fund and Funding Requirements, October 8, 1990. The Special Study used a very conservative "worst case analysis" which we believe substantially overstates the SIPC advances likely

handle multiple broker-dealer failures, including the hopefully unlikely event of a large broker-dealer failure. For the future, the Commission would like to see the size of the fund continue its recent satisfying growth.

Broker-dealers must meet capital standards based on daily mark-to-market accounting. When they fall below mandated capital levels they must cease securities activities until that capital deficiency is corrected. In addition, there are strict limitations on broker-dealers' use of customer funds and securities. 2/ As a result of these protections, broker-dealer failures on average cost the SIPC Fund far less than bank or thrift failures cost the bank insurance funds.

In contrast to bank failures that have cost the FDIC more than a billion dollars on several occasions, the largest single payout in the history of SIPC was only $32.5 million. Furthermore, in part because of the tough capital standards and the fact that broker-dealers are shut down quickly when they fall below mandated capital levels, the number of SIPC liquidations has been very small both quantitatively and in relationship to the number of SIPC members. From its inception in 1970 through January 31, 1991, SIPC has handled 221 insolvencies. Since 1980, the SIPC has handled less than 80 failures, while thousands of bank and thrift failures were handled by the FDIC and FSLIC during this period.

The operation of the Commission's net capital and customer protection rules, the examination and oversight mechanisms of the Commission and self-regulatory organizations, and annual auditing by independent public accountants have permitted the Commission and the self-regulatory organizations successfully to wind down broker-dealers, including large firms such as Drexel Burnham Lambert Inc. and Thomson McKinnon Securities Inc. ("Thomson"), without the need for SIPC intervention. In the Thomson self-liquidation, over 450,000 active customer accounts with property totalling $10 billion were transferred to other broker-dealers, thereby avoiding a SIPC liquidation.

---

required in liquidating a large broker-dealer.

2/ Unlike banks, which can use customer deposits in their business, the Commission's customer protection rule requires broker-dealers to have possession or control of all fully-paid and excess margin securities of customers and prohibits broker-dealers from using customer free credit balances to finance their own inventory positions, fixed assets or operating expenses. All customer fully-paid and excess margin securities are required to be maintained free of all claims or liens.

The current level of aggregate securities industry capital is near an all time high, as is the balance of the SIPC fund. Because of the strong industry capital position, the strong regulatory regime applicable to broker-dealers, SIPC's historical experience in liquidating broker-dealers, and the Commission's experience in winding down large broker-dealers without the need for SIPC intervention, the Commission considers that the current resources of the SIPC are adequate to handle any reasonably foreseeable brokerage failures. However, as indicated we would prefer to see the fund continue to grow in size for the future.

Q.2.b. Are you confident that the SIPC fund is sufficient?

A.2.b. See Response to question 2.a.

Q.2.c. Are any changes in the SIPC program warranted?

A.2.c. We believe that SIPC is doing a good job, and that no major changes in the Securities Investor Protection Act of 1970 ("SIPA") program are warranted at this time. However, it may be useful to consider adding the Chairman of the Commission as a member of the board of directors of SIPC in order to provide greater awareness of SIPC operating conditions to the Commission on a regular basis.

Q.3.a. The Latin Investment Corporation, located here in Washington, was accepting deposits from non-English speaking immigrants who believed it was an insured bank. Latin Investment, however, was not a bank and the deposits were not insured. A run developed, causing the institution to fail. It is uncertain whether the depositors will receive back all or some of the funds they deposited.

Press reports indicate that the SEC was aware of the situation, but did not act because the agency believed that the banking agencies should act on this issue. Once Latin Investment failed, the SEC took action against the company and its management.

a. Do you think the SEC could have taken action prior to the run on Latin Investment? Should the SEC have done so?

A.3.a. In April 1987, after an initial inquiry into the activities of Latin Investment Corporation ("LIC"), the staff of the Commission contacted the District of Columbia's Office of Banking and Financial Institutions ("OBFI") to advise that office of the staff's concern that LIC was operating as an unchartered and uninsured bank. The staff provided OBFI with information it

had obtained and offered to provide further information if needed.

The Commission staff considered the possible application of the federal securities laws relating to the potential sale of unregistered securities by LIC. However, those provisions provide for an exemption from the registration requirements of the federal securities laws for entities that operate as banks and are regulated by banking authorities. The staff understood from its discussions with OBFI officials that LIC was in the process of applying for a District of Columbia bank charter, and that OBFI was taking steps to ensure that LIC would do so.

In January 1988, the SEC staff again contacted OBFI because it had received additional information that LIC was still operating without a bank charter. The staff advised OBFI that, in the event OBFI was unwilling or unable to pursue the matter, the Commission staff intended to do so. The Commission's staff was assured at that time that OBFI was actively pursuing the matter.

In November 1988, the SEC staff contacted OBFI a third time to advise it that the staff was continuing to receive information that LIC was operating as a bank. My understanding is that OBFI informed the Commission staff that it was taking steps to have the D.C. Corporation Counsel take legal action to force LIC to comply with D.C. banking laws and subject itself to appropriate regulation of its activities.

From April 1987 until the recent revelations, the Commission's staff believed, based upon assurances provided by senior officials of OBFI, that OBFI was taking steps to ensure that LIC would comply with the District of Columbia's banking laws. The Commission staff determined in 1987 that, based upon the provisions of the Securities Act of 1933 which exempt the sale of bank-issued securities from the registration requirements of the federal securities laws, District of Columbia bank regulatory authorities had primary jurisdiction to pursue the matter. Indeed, courts have held that compliance with state banking laws would remove LIC from the Commission's jurisdiction. See, e.g., Taffin v. Levitt, 865 F.2d 595 (4th Cir. 1989) (holding that certificates of deposit issued by bank subject to system of comprehensive state banking regulation were not securities for purposes of federal securities laws), affirmed on an unrelated issue, 110 S.Ct. 792 (1990). Nonetheless, the Commission staff continued to maintain contact with OBFI through 1987 and 1988 and advised it that the Commission staff intended to pursue an investigation if OBFI was unwilling to do so.

In approximately early December, 1990, the Commission staff learned not only that LIC had not obtained a bank charter, but also that the principals of LIC were using investors' funds for

their personal benefit. After an expedited investigation, on December 21, 1990, the Commission filed an action against LIC and its three principals alleging violations of the registration and antifraud provisions of the federal securities laws. The Commission also sought and obtained a temporary restraining order which, among other things, froze the individuals' assets to assure their availability in the event the Court ultimately ordered disgorgement and restitution for the benefit of LIC's depositors. On January 17, 1991, the Commission obtained a preliminary injunction continuing the asset freeze. Unless the Commission's pending action is resolved without an adjudication, the district court will decide the dispositive legal issue presented: are the "pass-books" issued by LIC securities as defined by Section 2(1) of the Securities Act of 1933? The Commission, relying heavily on the Supreme Court's 1990 decision in Reves v. Ernst & Young, 108 L. Ed. 2d 47 (1990), will continue to argue that the pass-books are securities, particularly in light of the absence of "another regulatory scheme [that] significantly reduces the risk of the instrument, thereby rendering the application of the Securities Act unnecessary." Id. at 61.

As should be unequivocally clear from the chronology of the LIC matter, the Commission repeatedly referred concerns regarding LIC's activities to OBFI, and the Commission was advised on several occasions that OBFI was taking appropriate action under applicable law. Thus, the Commission seems to have done everything possible to encourage the banking authorities of the District of Columbia to take action. This tragic situation reveals the problems that can result from uncertainty in the law as to whether investment instruments issued by state banking institutions are securities for purposes of the federal securities laws. See, e.g., Taffin v. Levitt, 865 F.2d 595 (4th Cir. 1989) (holding that certificates of deposit issued by bank subject to system of comprehensive state banking regulation were not securities for purposes of federal securities laws), affirmed on an unrelated issue, 110 S.Ct. 792 (1990). As a result, where the Commission believes that there is inadequate protection for investors in certain type of instruments issued by state banking institutions, it typically urges state banking authorities, as it did here, to take appropriate enforcement action.

Q.3.b. Do you think the bank regulatory agencies could have taken action prior to the run on Latin Investment? If so, what would have been the appropriate agency? Should that agency have taken action?

A.3.b. Under the bank regulatory scheme in effect in the District of Columbia before 1986, banks in the District of Columbia were regulated by the Office of the Comptroller of the Currency. In 1986, that regulatory authority was shifted by federal statute to OBFI. As noted before, after being advised by

the Commission in 1987 of LIC's banking activities, OBFI informed the Commission staff that it was taking appropriate action. OBFI further informed the Commission staff at another point that it was referring LIC to either the D.C. Corporation Counsel or U.S. Attorney's Office for legal action as a result of LIC's failure to register as a bank.

Q.3.c. A Washington Post article published on January 3 stated that unchartered, uninsured financial institutions, similar to Latin Investment Corporation, "are operating in immigrant communities throughout the nation." Is this true, and if so, does the SEC intend to take steps against these institutions to protect the "depositors?"

A.3.c. The Commission's Division of Enforcement is attempting to identify other entities that hold themselves out as "banks" but are not subject to banking regulatory authority. The Division is currently investigating one such entity in the D.C. area. Banking authorities are also investigating the activities of the same entity. The Commission will take steps to protect customers of any such firm if the OBFI does not take prompt action in that matter. The Commission staff is in close contact with the OBFI and will soon know whether it is necessary for the Commission to take such steps.

Q.4. In my opening statement, I noted that trading on exchanges has been delayed or stopped at least four times in ten months.

Q.4.a. What costs, if any, are associated with these trading delays or halts?

A.4.a. Although we have not attempted to quantify the costs of the recent trading halts, we believe that those costs, for a variety of reasons, have not been extensive. First, the trading halts occurred on days when, even if the halts had not occurred, volume would be expected to be light. Second, the halts were for relatively brief periods of time, ranging from 90 minutes to approximately three hours. Finally, the halts created no systemic risk to the financial system, but rather simply deferred the opportunity for some orders to be executed.

Q.4.b. Is there any pattern to what is causing these trading delays or halts?

A.4.b. A review of the events causing the most recent trading delays - the August 13th Consolidated Edison substation fire and subsequent power outage, the November 23rd New York Stock Exchange electrical problem, the December 27th Consolidated Edison fire affecting the building housing the Securities Industry Automation Corporation ("SIAC"), and the January 4th,

1991, AT&T telephone line outage - demonstrates that there is no common thread to these events. Rather, they were simply a series of independent events compressed in a fairly narrow period of time. For example, the electrical events ranged from a significant fire and blackout at the power company's facilities to a purely internal problem at the NYSE. Further, the AT&T problem was entirely unrelated to any electrical event.

Q.4.c. What steps is the SEC taking to prevent these delays from occurring?

A.4.c. The Commission is committed to ensuring that SROs have adequate emergency contingency plans in place, and will continue to monitor the progress that the SROs are making. The recent difficulties with power and telecommunications systems demand continuing attention to the disaster recovery capabilities of the markets. The Commission's Automation Review Policy ("ARP") calls on the exchanges and the NASD to formulate contingency plans, among other things. The exchanges do, in fact, have such plans and continue to improve and enhance them. Given the increasing reliance of our markets on automated trading and clearance systems, the Commission has a clear responsibility to oversee the soundness of the technological infrastructure of our markets. Through its continuing administration of the ARP, the Commission will seek to ensure that the exchanges and the NASD devote sufficient attention and resources to this area.

The systems operated by the markets have improved greatly over recent years as the markets have devoted increasing resources to contingency planning, among other issues related to automation. In addition, the overall ability of the exchanges to recover from events beyond their control (such as power outages) will improve further with the completion of a new back-up facility for the computers that support the NYSE, Amex, and the national information dissemination and clearance systems in mid-1992. Moreover, the Commission is working with the exchanges, clearing organizations, and the NASD to ensure the maintenance of adequate backup electrical and other facilities for systems critical to the full functioning of the national market.

With respect to the Commission's role in connection with the increasing importance of automation in the securities industry, in March, 1990, the Commission created a new office within the Division of Market Regulation that will oversee and review automated systems at the SROs.

Q.5. Another major development over the last several years is the increase in trading that occurs off an exchange.

Q.5.a. What function do stock exchanges serve that off-market trading does not satisfy?

A.5.a. The registered stock exchanges have provided both retail and institutional investors with regulated, liquid markets available on a continuous basis, in which quotations and transaction prices are highly visible. 3/ Off-exchange markets in listed securities, on the other hand, generally have provided an environment in which individual securities or portfolios of securities can be traded on a more episodic basis, at prices either negotiated by participants or derived from the "primary" market in which those securities are traded. Off-exchange activity includes traditional third market-makers who provide regular, two-sided markets in listed securities and may provide guaranteed execution systems that execute small public orders at the best bid or offer. They also include various bulletin board systems that allow broker-dealers and professional investors the opportunity to display an interest in buying a security or portfolio of securities, usually in large size. This off-exchange environment traditionally has been favored by some institutional investors, but it has not been used by individual investors to any significant degree. However, some third market-makers also now operate guaranteed execution systems that provide derivative executions for small public orders. In either case, however, off-market trading depends on the activity of the primary exchange market to price the security properly.

Q.5.b. If off-market trading is primarily used by institutional traders, is it fair to allow off-market trading to occur when the exchanges are closed?

A.5.b. Yes. To date, the off-market trading systems in listed securities that operate after-hours, most notably the crossing networks operated by Instinet Corporation and Jefferies & Company, Inc., afford participants the opportunity to correct imbalances in their own positions by trading large blocks of particular securities traded on exchange markets, at prices derived from the price of those securities on the primary market. Retail investors are not precluded from access to these markets. However, because to date there has not been any substantial demand for access to these markets on the part of retail investors, the markets have in large measure evolved to meet the trading needs of large institutions. In this connection, we note, however, that the NYSE recently has proposed an after-hours trading session that would be fully available to retail investors.

3/ With respect to non-listed securities, NASDAQ/NMS has provided both individuals and institutions with an OTC market that is highly visible and liquid.

One of the principal fairness issues raised by the existence of off-exchange markets involves the transparency of these markets. It is important that participants be able to gauge the market for particular securities by having access to the price at which the most recent transaction has taken place. In the United States, all transactions effected by a broker-dealer in listed securities during the trading hours of the Consolidated Trade and Quotation Systems --whether taking place on or off a stock exchange -- are reported publicly on a real-time basis. Off-exchange transactions effected by broker-dealers during these hours are as transparent as exchange transactions. The Commission is working to increase the transparency of off-exchange markets that trade outside the hours of the NYSE. Through groups like the International Organization of Securities Commissions, the Commission is also seeking to enhance the transparency of foreign markets for U.S. securities.

Q.5.c. Why, if at all, are the stock exchanges still needed?

A.5.c. As noted, the stock exchanges continue to provide public investors with regulated, liquid, continuous, and visible markets that are favored by a great number of investors, both retail and institutional. In light of the fact that the majority of both share and dollar volume in listed shares occurs on the stock exchanges, it is fair to say that the stock exchanges continue to meet investors' needs. They provide accessible, continuous, liquid markets in which a variety of securities can be traded, at low cost, on a regulated basis, and at prices that reasonably reflect the market for the traded securities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM

RICHARD BREEDEN

Questions of Senator Terry Sanford -- Letter of January 14, 1991

Q.1. Mr. Breeden, you commented in your testimony on the success of the Securities Investor Protection Corpcration ("SIPC"), and I am certainly glad to hear that you consider the SIPC fund to be sound and operating effectively.

However, a number of cases have been brought to my attention which suggest that the SIPC may not be providing the protection to small investors that many in Congress and the public might believe is being provided.

Has the SEC received many complaints from small investors suggesting that SIPC is not paying claims that these small investors believed would be paid? If so, what is the nature of those complaints and how is the SEC handling them?

A.1. The current complaint tracking system does not isolate this particular type of complaint against SIPC and, in researching the most likely complaint category in which this type of complaint might be found, we have identified less than a dozen complaints received by the Commission during the last year. Generally, these complaints turn on the issue of whether the claimant is a customer within the meaning of the Securities Investor Protection Act of 1970 ("SIPA"). 4/ In responding to these complaints, the Commission staff would gather facts regarding the claims. Where appropriate, the Commission staff has encouraged SIPC to enter cases or has asked for additional information to determine whether the Commission should

---

4/ Under the SIPA, the definition of customer is contained in the statute. Section 16(2) of SIPA provides that

> "[t]he term 'customer' of a debtor means any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term 'customer' includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purposes of purchasing securities . . . ."

participate in an ongoing SIPA liquidation proceeding. 5/ We believe, based on our experience over the years, that SIPC is doing a good job and follows the SIPA statute in filing for and conducting liquidation proceedings. Finally, as indicated in our response to your second question, we believe there may be a need for disclosure requirements where SIPC member broker-dealers share offices and personnel with a non-SIPC member affiliate.

Q.2. I am particularly concerned that SIPC may be adopting an overly technical and narrow definition of a "customer" of a broker-dealer. It is my understanding that SIPC continues to define as "customers" only those persons who make their investment checks payable or deliver cash funds directly to the broker-dealer in the exact name of the broker-dealer. This may have the effect of precluding recovery by those who clearly entrusted funds to a broker-dealer for the purchase of securities, but whose checks may have been payable to the broker himself or an affiliated company of the broker-dealer. This definition has led SIPC to refuse compensation to many investors whose payments went to other than the broker-dealers but were made precisely as the broker-dealer directed. How would you assess SIPC's interpretation of "customer"?

A.2. We understand that SIPC's position is that the statutory definition of customer in SIPA requires that customers have entrusted their cash or securities to an entity that is a member of SIPC. SIPC's view is that entrustment to some other entity that is not a member of SIPC does not meet the statutory requirement. SIPC indicates it relies on objective factors to make its determination. For example, SIPC indicates that it has protected customers whose checks were made payable to entities other than the SIPC member where the customer subsequently received a confirmation of the transaction from the SIPC member or a monthly statement reflecting the transaction from the SIPC member. Nevertheless, we understand that there have been claimants that have dealt with an individual who was associated with two entities -- one a SIPC member broker-dealer and the other a non-SIPC member, where both entities operated out of the same offices and used essentially the same personnel. SIPC, as trustee, has determined based on the evidence that those claimants had not entrusted their cash and securities to the SIPC member and were not customers of the SIPC member within the meaning of SIPA. Of course, a SIPC determination as trustee in a liquidation proceeding is not final, and any claimant who disagrees with the trustee's determination has the right to

---

5/ Under Section 5(c) of SIPA, the Commission may, on its own motion, file notice of its appearance in any proceeding under the SIPA and may thereafter participate as a party.

oppose that determination before the bankruptcy court and to appeal any decision by the bankruptcy court. Finally, in view of the concern that the operation of a non-SIPC affiliate that has a similar name and the same personnel and offices as the SIPC member can keep customers from appreciating that transactions with different affiliates may carry different protection, the Commission staff has commenced a review to determine whether disclosure requirements should be adopted in order to reduce the potential for investor confusion. The Commission will also review definitional practices that may inappropriately limit the scope of the definition of customer.

Q.3. I am also concerned that many small investors may be getting caught between two different regulations. As you know, many small investors use smaller broker-dealers to handle their accounts. Many of these smaller broker-dealers are "$5,000 broker-dealers" who, because of their relatively small capital requirements, are not permitted to operate as clearing brokers, but act only as introducing brokers. As introducing brokers, they are prohibited from holding customers' securities or customers' funds. They therefore cannot accept investment checks payable to their order.

However, SIPC interprets the statute governing their responsibilities as permitting payment only to those persons who make their investment checks payable to the broker-dealer or deliver cash funds that are actually deposited in the broker-dealer's account. The small investors using introducing brokers may therefore be caught if they make payments to their broker-dealer, only to find later that such payments are not covered by SIPC.

Do you see a contradiction in these two interpretations? If so, how would you remedy this situation? If not, what remedy do you think is appropriate for those who may have deposited funds in good faith with a broker-dealer, usually at the clear direction of the broker-dealer, who later find out they are not technically a "customer" of the broker-dealer within the meaning of term as interpreted by SIPC?

A.3. There is, in fact, not a "gap" or contradiction in the operation of, on the one hand, the rules relating to net capital and those relating to customer deposits and SIPC's coverage, on the other. Currently, the Commission's net capital rule allows certain firms that do not carry customer accounts or clear customer transactions to maintain minimum net capital of only

$5,000. 6/ Paragraph (a)(2) of Rule 15c3-1 provides for the $5,000 minimum net capital requirement and seeks to restrict an introducing firm's access to customer funds and securities in such a way as to limit the amount of losses that investors are exposed to resulting from the insolvency of a firm that maintains only $5,000 in net capital. As a means of limiting such exposure, a broker-dealer operating pursuant to paragraph (a)(2) of the net capital rule may not carry or clear customer accounts and must promptly forward to its clearing or carrying firm all of the funds and securities of customers received in connection with its activities as a broker-dealer. The Division of Market Regulation has interpreted this provision to mean that a $5,000 introducing firm may not routinely receive customer funds and securities. If a firm does, it loses its exemption and must maintain net capital of $25,000.

As indicated earlier, SIPC protects customers that entrust their funds and securities to a SIPC member broker-dealer, including a clearing firm or a $5,000 introducing broker-dealer. Thus, if a customer makes his check payable to an introducing broker-dealer or delivers cash or securities to the introducing broker-dealer and the broker-dealer converts the money and fails financially, SIPC would protect those customers.

Q.4. I am also concerned about the growing number of reorganizations of public limited partnerships, commonly called "rollups." A number of my constituents have contacted me to express their concerns that they believe they have been given an unfair deal in such rollups. Many complain that the small investor has very little say in these rollups and that the resulting securities often sell at deeply discounted levels from the perceived values of the partnership interests prior to the rollup. I have also received complaints about the large fees and administrative costs being absorbed by the general partners in many of these transactions.

What is the SEC doing in this area? Does the SEC believe that abuses are occurring? If so, what steps does the SEC intend to take to curb the abuses? If not, why is there a growing perception that many investors are getting a raw deal from these rollups?

A.4. The Commission is in the process of evaluating the concerns that have been raised about rollups. A report on this subject is expected to be provided by the Commission to the Committee in the next few weeks. While many investors may have

---

6/ See Rule 15c3-1(a)(2) under the Securities Exchange Act of 1934.

experienced unsatisfactory returns from such transactions, the Commission is actively reviewing whether violations of disclosure and other requirements of the federal securities laws have occurred.

Q.5. Mr. Breeden, I would also like your comments on a number of issues raised in an article that appeared on the front page of the Wall Street Journal on December 14, 1990. The article concerns fees and dividends paid to Morgan Stanley as a result of their involvement with Burlington Industries. I have attached a copy of the article. The basic thrust of the article is that Morgan Stanley collected $176 million in fees from the captive Burlington, while investing only $46.3 million in the corporation. During the time that the $176 million in fees was paid, Morgan Stanley controlled the Board of Directors of Burlington.

I would like your comment on the propriety of the following:

Q.5.a. Comment on the propriety of: a fee Morgan Stanley charged of $8.25 million or 4% of the value to underwrite $212.5 million in junk bonds, at a time when the average fee for such services was 3.02%

A.5.a. The Commission does not regulate the underwriting fees charged by broker-dealers. The terms of the transaction, must be disclosed in the offering statement. Underwriting fees are set by the marketplace as a result of competition among broker-dealers.

The NASD does review the fees charged by broker-dealers in connection with public offerings of securities. Specifically, it reviews all offerings to determine whether the "underwriting or other arrangements in connection with or related to the distribution, or the terms or conditions relating thereto, when taking into consideration all elements of compensation and all of the surrounding circumstances and relevant factors, are unfair or unreasonable." 7/ In its review of the offering documents, the NASD analyzes each element of compensation to determine if it constitutes underwriting compensation. All items identified as underwriting compensation are then aggregated, and total compensation is expressed as a percentage of gross offering proceeds. The resulting percentage is then reviewed against the NASD's guidelines to determine whether the terms are fair and

---

7/ See Interpretation of the Board of Governors, Review of Corporate Financing, NASD Manual, Art. III, § 1, ¶ 2151.02.

reasonable. Participation by an NASD member in an offering when the NASD had determined that any terms were unfair or unreasonable would constitute a violation of the NASD's rules.

This offering was reviewed by the NASD, and the terms and conditions were found by the NASD to be fair and reasonable. It is our understanding from the NASD that Burlington Holdings, Inc. and BII Acquisition Corp. were organized by Morgan Stanley to effect the acquisition of Burlington Industries, Inc. We further understand that, after the acquisition, several classes of notes and debentures were offered, among them the junk bonds in question. These notes and debentures were part of the $1.679 billion restructuring of the company. (The discount charged in connection with the offering of the different notes ranged from 1.75 to 3.5%.) This money was used to repay a loan to a consortium of banks totaling $250,000,000 and to extinguish a series of bridge notes totaling $917,300,000 held by an affiliate of Morgan Stanley.

Due to the conflicts-of-interest arising when an underwriter, such as Morgan Stanley, participates in the sale to the public of securities of an affiliate, such as Burlington, the NASD required the use of a qualified independent underwriter to price the deal and to perform due diligence. 8/ Merrill Lynch served as the qualified independent underwriter, and the fees it charged also were included as underwriting compensation. With respect to the discount charged by Morgan Stanley, it is relevant to note that, at the time this transaction was consummated, Drexel Burnham underwrote approximately 80% of all junk bond offerings. 9/

Q.5.b. Comment on the propriety of: the required payment by Burlington to Morgan Stanley of a dividend of $56 million in conjunction with the establishment of an Employee Stock Ownership Plan, based on a share price that was almost four times the price Morgan Stanley had paid for the stock less than two years earlier.

8/ See Schedule E to the NASD By-Laws, NASD Manual ¶ 1881.

9/ Morgan Stanley has responded to the Wall Street Journal article. See Wall Street Journal, January 21, 1991, letters to the Editor. Morgan Stanley claims that its "'white knight' bid won in a four-way competitive auction. Morgan Stanley further claims that its offer was unanimously approved by Burlington's board because it offered shareholders the best price and committed to keep Burlington an independent company". Morgan Stanley further argues that the "fees we earned were within industry norms for the numerous complex transactions underwritten." However, I do not express any opinion concerning the validity of the arguments set forth by Morgan Stanley.

A.5.b. Generally, the obligations owed by directors, officers, and controlling shareholders of corporations are defined by state law. Following the leveraged buyout, Burlington Holdings and its subsidiaries were incorporated in Delaware. Actions by the board, including decisions to approve dividends, would therefore have been subject to Delaware law, including its application of the business judgment rule. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Weinberger v. UOP Corp., 457 A.2d 701 (Del. 1983). See also Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952) (controlling shareholders held to owe minority shareholders a fiduciary obligation not to use their control of the corporation to take unfair advantage of the minority).

The purchase of shares by an Employee Stock Option Plan ("ESOP") of the sponsoring corporation's shares is subject to fiduciary obligations established by Employee Retirement Income Security Act of 1979 and enforced by the Department of Labor ("DOL"). Generally, the ESOP is required to receive "adequate consideration" for its investment, which has been interpreted to mean that it can pay no more than fair market value for the shares it receives. The DOL has taken the position, at least in the context of a leveraged buyout in which an ESOP is a participant, that the consideration received by the ESOP must be fair in light of the consideration and rate of return of other post-buyout investors. 10/ It is not clear whether this position would be applied with respect to an ESOP investment occurring two years after the buyout. Obviously, the aggregate prices charged to the Burlington ESOP raise legitimate questions as to whether applicable fiduciary duties were satisfied in connection with the transaction. However, these are issues arising under state law and ERISA, not the federal securities laws.

Q.5.c. Do you see conflicts in investment banking firms having a controlling interest in the corporations that they advise and do underwriting for? If so, how should those conflicts be addressed?

10/ Letter from Norman P. Goldberg, Counsel for Fiduciary Litigation, Plan Benefits Security Division, Department of Labor, to Charles R. Smith (Nov. 23, 1984), reprinted in 12 Pens. Rep. (BNA 52) (Jan. 7, 1985)(Blue Bell transaction); Letter from Charles Lerner, Assistant Administrator for Enforcement, Department of Labor, to Wilson H. Ellis, Jr., Vice President, Citizens and Southern Banks, reprinted in 12 Pens. Rep. (BNA) 1182 (Aug. 25, 1985)(Scott & Fetzer Co. transaction).

A.5.c. Yes. Conflicts of interest may exist for investment banking firms holding a controlling interest in their clients, as for other controlling shareholders that may have conflicting interests with the interests of minority shareholders. Generally speaking, such conflicts of interest are governed by state corporate law rather than the federal securities laws. Santa Fe v. Green, 430 U.S. 462 (1977). State law has recognized that a controlling shareholder has a fiduciary duty to minority shareholders not to use its control of the corporation to take unfair advantage of the minority. E.g. Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952) 11/

While questions relating to obligations owed to minority shareholders by controlling shareholders of a corporation are a matter of state law, the federal securities laws do provide some protections to prospective investors in publicly-held corporations controlled by broker-dealers. Potential conflicts arising out of broker-dealer affiliate transactions are addressed by: issuer disclosure requirements; 12/ independent pricing of affiliate underwritings; 13/ and disclosure to customers of an underwriter's controlling interest in an issuer. 14/

11/ We understand, however, that Morgan Stanley held 100% of the voting stock of Burlington Northern at the time of the transactions raised in your question. Holders of the remaining, non-voting equity interest included Bankers Trust and Equitable Life Insurance Co. of America. The equity was not publicly traded or registered with the Commission.

12/ For example, Regulation S-K under the Securities Act of 1933 requires registration statements of new issues to contain extensive disclosure relative to the new issue, the issuer, and the issuer's affiliates, as well as information regarding the nature of the underwriter's interests in the issuer and the underwriters' compensation.

13/ Potential conflicts with respect to the pricing of public underwritings conducted by a broker-dealer on behalf of an affiliate (or to benefit an affiliate) are addressed by a requirement of the National Association of Securities Dealers, Inc. ("NASD"), which generally provides that, if a firm underwrites its own securities or the securities of an affiliate, it obtain an independent pricing. See NASD Schedules to By-Laws, Schedule E.

14/ Rule 15c1-5 under the Securities Exchange Act of 1934, 17 C.F.R. 240.15c1-5. In addition, Rule 15c1-6 requires a broker-dealer to disclose to its customers its interest in any distribution of securities, including any right to proceeds.

In addition, under the anti-fraud provisions of the federal securities laws, a broker-dealer firm has a duty not to take advantage of any material inside information it obtains as a result of its relationship with a controlled corporation. To deal with such potential conflicts, multi-service broker-dealer firms already have established preventative procedures to address the flow, and inappropriate use, of material inside information. These procedures include Chinese Walls, restricted lists, and watch lists. Such procedures and policies have been in existence for some time as a legal defense for broker-dealers against liability in the insider trading context. However, recently Congress mandated that broker-dealers institute such procedures and policies in the Insider Trading and Securities Fraud Enforcement Act of 1988. 15/

Finally, the availability of private and Commission rights of action under the antifraud provisions of the federal securities laws serve generally to deter abusive conflicts of interest that violate the federal securities laws. For example, in cases involving insider trading, the Commission is authorized under Section 21A of the Securities Exchange Act to bring civil actions and to obtain a penalty up to three times the amount of the profit gained or loss avoided as a result of the violation. Recently, in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Congress granted the Commission the authority to obtain civil money penalties in other cases that involve willful violations of the federal securities laws. The Commission expects these newly-adopted provisions to have a significant deterrent effect in cases involving violations of the federal securities laws. However, such remedies will not apply to violations of state laws concerning corporate governance and establishing relevant duties of officers, directors and controlling persons.

15/ For a description of the use of Chinese Walls, restricted and watch lists by broker-dealer firms, See Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information, Securities and Exchange Commission (March 1990).

THE WALL STREET JOURNAL FRIDAY, DECEMBER 14, 1990

Captive Client

Morgan Stanley Found A Gold Mine of Fees By Buying Burlington

It Drew Off Millions, Loaded Burlington With Debt, Then Quietly Bowed Out

Soul-Searching on Wall Street

By GEORGE ANDERS
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—When Morgan Stanley & Co. took over Burlington Industries Inc. in 1987, it promised a bright future for the company. The patrician Wall Street investment bank talked enthusiastically of "working with management to improve immediate and long-term returns."

But 3½ years later, Burlington is in the worst financial shape of its 67-year history. The big textile company is running deep in the red, its junk bonds are trading as low as 33 cents on the dollar, and some of its core operations, like its research department, have been chopped to pieces by cost-cutting drives. Layoff after layoff has swept the company. With a downturn in the textile business now adding to Burlington's troubles, its chairman, Frank Greenberg, has asked employees to make "an extra effort to get us through this period."

Morgan Stanley, on the other hand, has done just fine. It has collected some $176 million from the captive textile company, including more than $120 million in investment-banking fees and another $56 million in a special dividend. Filings with the Securities and Exchange Commission show that nearly every time Burlington needed financial advice, Morgan Stanley turned on the meter. The firm has charged advisory fees for everything from underwriting Burlington's high-yield junk bonds to overseeing a blizzard of divestitures that disposed of some of Burlington's most modern operations.

The Fallout

The story of Burlington Industries raises troubling questions about Wall Street's foray into merchant banking in the 1980s, when securities firms went shopping for big industrial companies to add to their own portfolios. Between 1986 and 1989, firms such as Morgan Stanley purchased nine companies for $1 billion or more each. Burlington's chief executive, Mr. Greenberg, for one, can't hide his frustration at the outcome. He complains that, for all their acumen, Morgan Stanley's dealmakers are "from a different walk of life" than textile executives. At one point in an interview, Mr. Greenberg stops, leans forward and reflects on the turmoil Burlington has experienced since it was first put in play in 1987: "I just have one question for you. How did all this madness happen?"

Morgan Stanley executives who worked with Burlington decline to be interviewed. A review of SEC filings, however, shows that Morgan Stanley has insulated itself from Burlington's ordeal—drawing off huge fees but piling the debt for the $2.2 billion acquisition onto the textile company's books. Later, Morgan Stanley would back away from the severely weakened company, unloading most of its equity stake and relinquishing overall control back to Burlington.

Morgan Stanley's Bill

In 1987, Morgan Stanley took control of Burlington Industries in a leveraged buy-out, investing $46.3 million. While Burlington stumbled, Morgan Stanley reaped the following fees:

	FEES	(In millions)
1987	Tender offer	$ 1.5
	LBO transaction	29.1
	Bridge loan	16.1
	Junk-bond underwriting	40.0
1988	Divestiture	22.0
1989	Junk-bond underwriting	8.3
	Special dividend	56.1
	Recapitalization	2.5
1990	Retiring junk bonds	1.0
	Total fees and dividends	$176.6

Captive Client: After Morgan Stanley Took Control Of Burlington, Investment Bank Reaped Huge Fees

Continued From First Page

The fee binge appears to be causing some soul-searching at Morgan Stanley, considered one of the bluest of the blue-chip investment banks on Wall Street. Several Morgan Stanley clients say Joseph Fogg, the firm's investment banking chief, is worried that some of its buy-outs could sully Morgan Stanley's carefully cultivated image with America's top corporate clients. Mr. Fogg says through a spokesman that this is "hearsay" and declines to comment further.

Morgan Stanley first showed up at Burlington's door in May 1987 as a potential rescuer. Corporate raider Asher Edelman had been stalking the Greensboro, N.C., textile company for months, apparently determined to break it up and sell off the pieces. Burlington executives filed lawsuits to block his takeover bid and eventually accepted a leveraged buy-out of the company led by Morgan Stanley.

The securities firm put Donald Brennan and Alan E. Goldberg on the project. Mr. Brennan, the head of its buy-out group, is a chunky man in his mid-40s who was once a senior executive at International Paper Co. He has a rumpled, Middle America manner that corporate executives often find disarming. Mr. Goldberg is an investment banker in his early 30s who has worked at Morgan Stanley since getting an M.B.A. from New York University in 1979.

Messrs. Brennan and Goldberg's shrewd winning bid for Burlington required Morgan Stanley to put up only a small fraction—$46 million—of the $2.2 billion purchase price. Bank loans and later junk-bond offerings provided more than 90% of the money for the deal. Morgan Stanley walked away with all of Burlington's new Class A voting stock and control of the company. Bankers Trust and Equitable Life Assurance Society of the U.S., which invested money in the deal, got some non-voting stock. Burlington got the debt.

Right away, Burlington became a cash cow for Morgan Stanley. In its first 50 days of owning the textile company, Morgan Stanley collected $87 million in fees, nearly double what the Wall Street firm paid for its controlling stake. Among the fees was $29 million for "advising" Burlington on how to be bought by Morgan Stanley.

Morgan Stanley insisted in a later Burlington prospectus that all its fees "were no less favorable" than what another Wall Street firm might have charged. But in at least one instance, Morgan Stanley's fee appears unusually steep. The firm charged Burlington $8.25 million to underwrite sales of $212.5 million of junk bonds in 1989. That fee, equal to 4% of the bonds' value, was well above the average 3.02% that securities firms charged for junk-bond underwritings at the time, according to IDD Information Services Inc., a financial data firm.

Burlington management could hardly take issue with the bills: After all, Morgan Stanley now controlled its board.

For the first two years of the buy-out, Burlington embarked on a slim-down strategy that seemed to pay off financially. The company laid off 900 headquarters workers and sold 20 businesses. The divestitures generated $1 billion in cash, which Burlington used to pay down debt. Burlington's work force ultimately shrank to 27,500 from 44,000 in 1986 before Morgan Stanley arrived. The company also lost its status as the nation's biggest textile company.

Onlookers such as William Klopman, a retired Burlington chief executive, argue that the retrenchment "didn't have any logic at all." Even Burlington's Mr. Greenberg told an interviewer in 1988 that some divestitures were "difficult" to stomach, such as the sale of a top-of-the-line denim plant in Erwin, N.C., to archrival Dominion Manufacturing Co. But Wall Street was calling the shots.

Clearly, Morgan Stanley was in its element. From 1987 to 1989, its investment bankers cranked out dozens of neat blue binders packed with financial snapshots of

Burlington operations for sale. One buyer of a Burlington unit, textile executive Arthur Weiner, recalls Morgan Stanley's "brilliant" grasp of numbers and financing structures. While the divestitures jolted Burlington, they churned out cash, a chunk of which Morgan Stanley pocketed: The firm collected $22 million in advisory fees for Burlington's divestitures.

Relinquishing Some Control

Burlington seemed to be stabilizing by the fall of 1989. The slimmed-down textile company reported robust operating profit of $211.5 million for the fiscal year before interest and taxes, though it still had a small net loss because of its big interest bill. Analysts believed the company would be profitable in another year or two.

Then Burlington's managers began clashing with Morgan Stanley's dealmakers about the company's direction, according to Mr. Greenberg, the textile company's chairman. He recalls that, in a speech to his managers in 1989, he said it was his "ultimate goal to return the company to the control of the people who worked there. I didn't ever again want to have decisions about us made by third parties of any description."

Faced with a possible mutiny by Burlington management, Morgan Stanley helped devise a financial package that put some stock into employee hands, thus diluting the firm's control over Burlington. The package, however, also required that Burlington pay a $175.3 million dividend to its equity holders—chiefly Morgan, Bankers Trust and Equitable. The recapitalization ended up piling another $212.5 million of junk-bond debt onto the textile company.

Morgan Stanley's share of the dividend—$56 million—was so rich that it equaled more than half of the firm's earnings in 1989's third quarter. To the dismay of credit analysts, Burlington made the payout even though it now would be loaded down with a total of $1.6 billion in junk-bond debt. William Mendenhall, an analyst with Moody's Investors Service, says payment of the dividend amounted to the "decapitalization" of Burlington Industries.

"The dividend to Morgan Stanley is a problem," adds Malon Wilkus, an investment banker at American Capital Strategies of Bethesda, Md., who specializes in employee-stock plans. "It's an ugly part of this transaction."

A Matter of Price

Under the restructuring, a new company employee stock ownership plan bought 2.9 million newly issued shares of Class A voting stock, or 36% of the total outstanding—but not without a quarrel over what price the ESOP should pay. As Wilson Ellis, an Atlanta banker who helped create the ESOP, recalls it, Morgan Stanley's Mr. Goldberg insisted the employee plan buy its stock at $50 a share, five times the price Morgan Stanley paid just two years earlier. Mr. Goldberg, through a spokesman, disputes the $50-a-share figure, but won't elaborate.

It took a month of "aggressive negotiations" to get Messrs. Brennan and Goldberg to soften their position, Mr. Ellis recalls. The employees' plan finally secured its stock in closely held Burlington at $37.80 a share in August 1989, still nearly quadruple Morgan Stanley's cost. The appraisal firm of Houlihan, Lokey, Howard & Zukin, which had helped Morgan Stanley value Burlington in 1987, said the price was fair.

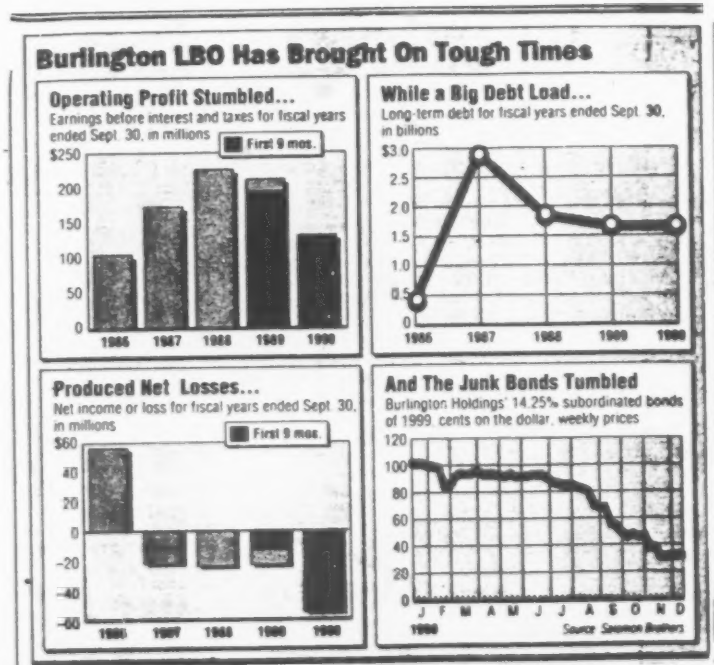
When it was all over, Morgan Stanley had extracted $64.6 million from Burlington through junk-bond underwriting fees and the dividend associated with the recapitalization. But there was more. Morgan Stanley also sent Burlington a bill for $2.5 million—a fee, the firm said, for advising the textile maker on the recapitalization.

Before long, Burlington faced new, more serious troubles. Its orders started to dwindle, as clothing sales cooled nationwide. The carpeting and drapery division ran into tough times because of a slowdown in housing starts. Since the takeover, Burlington had posted nothing but losses—its first ever—and now those losses were beginning to widen substantially. In the nine months ended June 30, 1990, the company reported a record $54.7 million deficit on sales of $1.73 billion. Analysts now say Burlington's finances are precarious. While the company "looks like a long-term survivor," says Salomon Brothers analyst Paul Shaum, "it's a weakened giant."

Bailing Out

Mr. Shaum estimates that Burlington's operating profit before interest, taxes, depreciation and amortization will total $260 million in fiscal 1991. That would fall slightly short of its $267.9 million interest bill. While Burlington has a little breathing room because some of its zero-coupon bonds don't pay interest until 1994, it could eventually face a cash crunch if its business doesn't improve.

But Morgan Stanley won't be around. As Burlington's outlook worsened in the past few months, the securities firm



sprinted for the exit. In October, Morgan Stanley sold all of its 4.2 million shares of voting stock to Burlington, thus relinquishing control. Burlington paid Morgan Stanley by issuing it some non-voting shares in the company plus $42 million face value of a new non-voting preferred stock with a relatively skimpy 9.5% yield, payable in more preferred stock.

The transaction appears to mark down the value of Morgan Stanley's stock, though the firm seemed willing to take the hit just to get out of Burlington. After all, Morgan Stanley had already "done well financially" through its investment in the company, Burlington's Mr. Greenberg observes. He says he pressed the Wall Street firm to accept a low price for its stock, arguing that it "would gain more in public relations" by selling on terms that Burlington could afford than by wringing more cash out of the company.

Facing the Future

Burlington's employee stock plan wasn't as fortunate, though. It hasn't made a cent yet from the stake it bought in the company. And in October, Houlihan Lokey valued the employees' stock at $14.62 a share—less than half the price paid 14 months earlier.

Holders of Burlington's $1.6 billion in junk bonds are also taking their lumps. If the textile business doesn't perk up, "there has to come a point where the [company's capital structure] doesn't look feasible," says Moody's Mr. Mendenhall. If the company has to restructure its debts, bondholders may well experience significant losses.

To be sure, most textile-industry bonds are suffering. But some investors say Morgan Stanley has made things worse for Burlington. "Morgan Stanley has ticked off a lot of clients," says a former Burlington bondholder, Gerald Unterman, head of Cypress Capital Management. "Morgan has an aggressive profile," he says. "They're just playing for themselves."

Burlington executives are hoping that an upturn in the textile business will rescue the company. But Mr. Greenberg adds that for Burlington to prosper, it will need "an environment where employees are working for themselves, instead of working for investment bankers."

If Morgan Stanley is troubled by the anger of bondholders or the fears of Burlington employees, it isn't letting on. When the Wall Street firm exited Burlington in October, Morgan Stanley's Mr. Brennan simply said in a statement that the move was in everyone's best interest.

Without any sign of irony, he added: "We have enjoyed the close relationship we have had with Burlington since 1987."